Audit Quality in Australia

A Strategic Review

The Treasury

March 2010
Consultation process

Request for feedback and comments

The Government is seeking your feedback and comments on the issues raised in the consultation paper including Treasury’s key findings.

The information will inform the Government’s proposed approach on these issues and also assist in meeting the requirements of the Office of Best Practice Regulation.

While submissions may be lodged electronically or by post, electronic lodgement is preferred. For accessibility reasons, please email responses in a Word or RTF format. An additional PDF version may also be submitted.

All information (including name and address details) contained in submissions will be made available to the public on the Treasury website, unless you indicate that you would like all or part of your submission to remain in confidence. Automatically generated confidentiality statements in emails do not suffice for this purpose. Respondents who would like part of their submission to remain in confidence should provide this information marked as such in a separate attachment. A request made under the Freedom of Information Act 1982 (Commonwealth) for a submission marked ‘confidential’ to be made available will be determined in accordance with that Act.

Closing date for submissions: COB 7 May 2010

Email: auditquality@treasury.gov.au
Mail: Audit Quality Strategic Review
Corporations and Financial Services Division
The Treasury
Langton Crescent
PARKES ACT 2600

Inquiries: Inquiries can be directed to Mr Peter Levy or Ms Genevieve Watson
Phone: 02 6263 3976/02 6263 3144
A robust financial reporting and auditing framework plays a critical role in well-functioning capital markets. An independent and quality audit provides a necessary external check on the integrity of financial statements. Transparent and credible financial reporting together with an effective audit function underpins confidence in our financial system and is essential for sound economic growth.

I am pleased to release Treasury’s discussion paper Audit Quality: A Strategic Review. The Treasury paper is timely because the global financial crisis and the general uncertain economic environment have presented the auditing profession with challenging risks and uncertainties. The global financial crisis has also highlighted the importance of audit quality in the context of the prudential regulation of banks and more broadly, the enhancement of market confidence.

The Treasury paper seeks to identify the key drivers of audit quality and to assess whether any measures should be taken to address any threats to these drivers of audit quality. Treasury has drawn on the experience, research and studies on audit quality undertaken in Australia, as well as foreign jurisdictions, including the UK and the US. Treasury’s paper is designed to focus on these issues and to facilitate informed debate with a view to achieving appropriate policy responses to these issues.

Treasury has concluded that our audit regime compares well in terms of international best practice and that no fundamental reform is required. Treasury is of the view that Australia’s financial reporting system and audit regulation is both robust and stable. This is critical in the context of the efficiency of our financial system and Australia’s sound economic growth.

The wide-ranging research undertaken by the Treasury has, however, identified a significant number of important policy issues that warrant consideration by the key stakeholders in Australia who have an interest in auditing. Treasury’s paper is designed to facilitate informed debate within Australia with a view to achieving appropriate policy responses to these issues. The paper should provide a blueprint for possible future reforms in this important policy area and add to the international debate on audit quality.

Treasury will be conducting a targeted consultative process with key stakeholders, including the Australian Securities and Investments Commission, the Financial Reporting Council, the Australian Prudential Regulation Authority, the Auditing and Assurance Standards Board, the major audit firms, the professional accounting bodies, the Australian Institute of Company Directors and ASX Ltd. Comments are also invited from other interested persons.

Treasury proposes to provide the Minister for Financial Services, Superannuation and Corporate Law with a report once the consultative process has been completed with a view to the Government considering any appropriate reform measures.

Jeffrey Lucy AM
Chairman
Financial Reporting Council
# Table of Contents

**Part 1: Introduction**
- The methodology adopted to assess audit quality ................................................................. 2
- The UKFRC’s Audit Quality Framework ...................................................................................... 2
- Advisory Committee on the Auditing Profession to the US Department of the Treasury .......... 4
- The Future of Auditing Report ..................................................................................................... 5
- International perspective of major global audit firms ................................................................. 5
- How Treasury proposes to use the strategic review paper .......................................................... 6

**Part 2: Executive Summary — Key Findings**
- Overview of Australia’s audit regulation framework ................................................................. 7
- Australia’s audit regulation framework in the context of audit quality ...................................... 7
- Audit review processes ................................................................................................................... 8
- ASIC audit inspection program ..................................................................................................... 8
- Professional accounting bodies’ quality reviews ......................................................................... 9
- The FRC’s auditor independence function .................................................................................... 9
- Audit firm arrangements and processes ....................................................................................... 9
- The culture within the firm ............................................................................................................ 9
- The skills and personal qualities of audit partners and staff ...................................................... 10
- The effectiveness of the audit process ......................................................................................... 10
- The reliability and usefulness of auditing reporting ................................................................. 11
- Auditor communication, expectations gap and standard audit report ....................................... 11
- Factors outside the control of auditors ....................................................................................... 12
- Corporate governance and the audit committee ........................................................................ 12
- Registered company auditors .................................................................................................... 12
- Auditor liability ............................................................................................................................. 13

**Part 3: Overview of Australia’s Audit Regulation Framework**
- Introduction .................................................................................................................................. 14
- Auditor independence .................................................................................................................... 15
- Comparative review of Australia’s auditor independence requirements ..................................... 18
- Australian quality control standards ........................................................................................... 18
- Australia’s audit regulation framework and market behaviour .................................................. 19
- Australia’s audit regulation framework and mutual recognition arrangements with overseas audit authorities ................................................................................... 20
- The global financial crisis: accounting and auditing issues ....................................................... 22
- G-20 Action Plan: accounting standards ..................................................................................... 22
- Auditing issues in uncertain economic times .............................................................................. 23
- Findings: Australia’s audit regulation framework in the context of audit quality ....................... 24
- Key finding 1 ................................................................................................................................. 24
- Key finding 2 ................................................................................................................................. 24
- Key finding 3 ................................................................................................................................ 25
- Key finding 4 ................................................................................................................................ 25
- Key finding 5 ................................................................................................................................ 25
- Key finding 6 ................................................................................................................................ 25
# Abbreviations

<table>
<thead>
<tr>
<th>Abbreviation</th>
<th>Full Form</th>
</tr>
</thead>
<tbody>
<tr>
<td>AASB</td>
<td>Australian Accounting Standards Board</td>
</tr>
<tr>
<td>AICD</td>
<td>Australian Institute of Company Directors</td>
</tr>
<tr>
<td>ANCAAR</td>
<td>Australian Centre for Audit and Assurance Research</td>
</tr>
<tr>
<td>APESB</td>
<td>Accounting Professional and Ethical Standards Board</td>
</tr>
<tr>
<td>AQRB</td>
<td>Audit Quality Review Board</td>
</tr>
<tr>
<td>ASIC</td>
<td>Australian Securities and Investments Commission</td>
</tr>
<tr>
<td>ASIC Act</td>
<td>Australian Securities and Investments Commission Act 2001</td>
</tr>
<tr>
<td>ASX</td>
<td>Australian Securities Exchange</td>
</tr>
<tr>
<td>AUASB</td>
<td>Auditing and Assurance Standards Board</td>
</tr>
<tr>
<td>Basel Committee</td>
<td>Basel Committee on Banking Supervision, Bank for International Settlements</td>
</tr>
<tr>
<td>CLERP 9 Act</td>
<td>Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Act 2004</td>
</tr>
<tr>
<td>Corporations Act</td>
<td>Corporations Act 2001</td>
</tr>
<tr>
<td>EU</td>
<td>European Union</td>
</tr>
<tr>
<td>FASB</td>
<td>US Financial Accounting Standards Board</td>
</tr>
<tr>
<td>FCAG</td>
<td>Financial Crisis Advisory Group</td>
</tr>
<tr>
<td>FRC</td>
<td>Financial Reporting Council</td>
</tr>
<tr>
<td>FSB</td>
<td>Financial Stability Board</td>
</tr>
<tr>
<td>Future of Auditing Report</td>
<td>ANCAAR research report titled <em>The Future of Auditing: Keeping Capital Markets Efficient</em></td>
</tr>
<tr>
<td>IAASB</td>
<td>International Auditing and Assurance Standards Board</td>
</tr>
<tr>
<td>IASB</td>
<td>International Accounting Standards Board</td>
</tr>
<tr>
<td>ICAA</td>
<td>The Institute of Chartered Accountants in Australia</td>
</tr>
<tr>
<td>IFAC</td>
<td>International Federation of Accountants</td>
</tr>
<tr>
<td>IFIAR</td>
<td>International Forum of Independent Audit Regulators</td>
</tr>
<tr>
<td>IOSCO</td>
<td>International Organisation of Securities Commissions</td>
</tr>
<tr>
<td>NIA</td>
<td>National Institute of Accountants</td>
</tr>
<tr>
<td>PCAOB</td>
<td>US Public Company Accounting Oversight Board</td>
</tr>
<tr>
<td>UKFRC</td>
<td>UK Financial Reporting Council</td>
</tr>
<tr>
<td>US Treasury Committee</td>
<td>Advisory Committee on the Auditing Profession to the US Department of the Treasury</td>
</tr>
</tbody>
</table>
PART 1: INTRODUCTION

1.1 High-quality financial reporting by companies and other entities and an effective audit function are recognised as key components of efficient capital markets and can have a direct impact on the cost of capital. Credible and transparent financial reporting is particularly important in an uncertain economic environment.

1.2 The importance of the credibility and integrity of the financial reporting and independent audit process has been highlighted by the global financial crisis. The nature of the global financial crisis and the depth and breadth of the current uncertain economic environment have affected most entities across most sectors of the economy. Consequently, many key aspects of an entity’s financial report have been affected. This has presented new complexities, risks and uncertainties for auditors. Treasury considers that the preparation of its strategic review of audit quality provides a timely opportunity to examine the implications of the global financial crisis on audit quality in Australia and to undertake a ‘stress test’ on the performance of Australia’s audit regulation framework and the audit function during the financial crisis.

1.3 The Financial Crisis Advisory Group (FCAG), which was formed to advise the International Accounting Standards Board (IASB) and the US Financial Accounting Standards Board (FASB) about the standard-setting implications of the financial crisis and potential changes in the global regulatory environment, made the following pertinent observations in the introduction to its report released on 29 July 2009:

Financial reporting plays an integral role in the financial system by striving to provide unbiased, transparent and relevant information about the economic performance and condition of business. Effective financial reporting depends on high quality accounting standards as well as the consistent and faithful application and rigorous independent audit and enforcement of those standards.

Financial reporting is of great importance to investors and other financial market participants in their resource allocation decisions and to regulators and other users. The confidence of all these users in the transparency and integrity of financial reporting is critically important to global financial stability and sound economic growth.¹

1.4 The global financial crisis has also highlighted the importance of audit quality in relation to the prudential supervision of banks and market confidence. The Basel Committee on Banking Supervision (the Basel Committee) has made the following observations:

In recent years, there has been a change in banking supervisors’ reliance on audited information and in the nature of the major external audit firms. Concerns about the risk of audit failures, the global expansion of the major audit firms, increased complexity of both accounting standards and financial instruments, and the challenges associated with fair value estimation processes, which have been amplified by the current market crisis, have reinforced bank supervisors’ need to be confident of audit quality.²

We also consider that a strategic review of audit quality in Australia is timely given that over five years have now passed since the major financial disclosure and audit reforms were introduced by the Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Act 2004 (the CLERP 9 Act).

The Methodology Adopted to Assess Audit Quality

The methodology adopted in this paper is to identify the key drivers of audit quality and to assess whether any measures should be taken to address any real or perceived threats to these drivers of audit quality.

Audit quality involves a wide range of inter-related factors such as the legal framework relating to audit regulation (including the company auditor registration system, the auditor independence regime in the Corporations Act 2001 and the accounting and auditing standards), the ethical standards applying to the members of the professional accounting bodies, the professional qualities and skills of auditors and their staff and the role and activities of the audit regulator — the Australian Securities and Investments Commission (ASIC) — and other bodies involved in the audit review process.

There are also other drivers of audit quality that relate to the practices and processes adopted within audit firms, such as the culture within the audit firm and the quality of the firm’s audit process, including the experience and technical expertise of the audit team and the audit methodology adopted by the firm.

The impact of the global financial crisis and the current uncertain economic environment have not affected the basic methodology adopted in the paper. However, it has been necessary for us to give greater emphasis and focus to particular risks that have arisen, such as the capacity of audit firms to respond to the complexity and uncertainty surrounding a range of accounting and audit issues in the current uncertain economic conditions.

Treasury’s strategic review has also had regard to important work that has been undertaken on audit quality in the UK and US and by international bodies. Our paper has also been informed by the major research project undertaken by researchers at the Australian Centre for Audit and Assurance Research (ANCAAR) within the Australian National University and the report ANCAAR released in mid-2009, The Future of Auditing: Keeping Capital Markets Efficient (the Future of Auditing Report).

The UKFRC’s Audit Quality Framework

The UK Financial Reporting Council (UKFRC) has undertaken an extensive study of audit quality — a discussion paper, Promoting Audit Quality, was released in November 2006, a report by the UKFRC on the responses to its discussion paper was published in October 2007 and then in February 2008, the UKFRC released The Audit Quality Framework which detailed the final version of the key drivers of audit quality and the indicators relevant to those drivers. In its discussion paper, the UKFRC acknowledged that there is no single agreed definition of audit quality that can be used as

---


a standard against which actual performance can be assessed and that limited transparency makes an assessment of audit quality difficult for those who rely on it.

1.12 The UKFRC identified five key drivers of audit quality, and considered threats to those drivers, in the areas of:

- the culture within an audit firm;
- the skills and personal qualities of audit partners and staff;
- the effectiveness of the audit process;
- the reliability and usefulness of audit reporting; and
- factors outside the control of auditors affecting audit quality.

1.13 There was widespread support from UK stakeholders for the framework of drivers of audit quality developed by the UKFRC. Treasury understands that the International Forum of Independent Audit Regulators (IFIAR) also endorsed the drivers of audit quality identified by the UKFRC. The Treasury acknowledges that the work that the UKFRC has undertaken in relation to audit quality has significantly informed the Treasury’s consideration of this issue. The UKFRC’s work in this field included extensive research and consultation processes.

1.14 Having regard to the increasingly international context in which auditing is now practised and the general global business environment, much of the work and conclusions of the UKFRC are relevant to Australia. However, while supporting the five drivers of audit quality identified by the UKFRC, Treasury considers that in the Australian experience, two additional factors should be recognised in the Australian framework as key drivers of audit quality:

- Australia’s audit regulation framework; and
- the audit review processes, and in particular, ASIC’s audit inspection program.5

1.15 The audit regulation framework and the audit review processes are key drivers of audit quality in this country because, while Australia has a federal constitutional system, it has been able to achieve a national system of corporations regulation as a result of an agreement between the Australian and the State and Territory governments involving the referral of powers to the Australian Government. This has been a major feat of government and an example of successful micro-economic policy implementation.

1.16 Australia’s national corporate regulatory system and the way it has been embedded within the framework of the Corporations Act is a distinguishing feature of Australia’s audit regulation framework compared with the regulatory systems in some foreign jurisdictions.

- ASIC, the key corporate regulator, is a statutory body established under federal legislation. All the other key bodies performing specified functions in relation to the audit regulatory framework have also been established under the umbrella of the national corporations legislation.

- The accounting standards, the auditing standards and the auditor independence requirements applying to audits under the Corporations Act are all legally enforceable under the Act. The

---

5 It is noted that the UKFRC Audit Quality Framework, ibid., recognises the regulatory environment that focuses on the drivers of audit quality as an indicator within the key driver of audit quality ‘factors outside the control of auditors’.
auditing standards require an auditor to comply with relevant ethical requirements, including those pertaining to independence, when performing audits, reviews and other assurance engagements.  

1.17 Another important reason why Treasury considers that the audit regulation framework and the audit review processes should be recognised as separate drivers of audit quality in their own right, is that the approach to audit regulation has changed and been enhanced since the spate of corporate failures in 2001-2002 (involving entities such as Enron in the US and HIH in Australia). Since that time, proactive, independent audit oversight processes have been established in most countries with developed market based economies such as Australia, Canada, Japan, the UK and the US. In the light of these developments, the UKFRC has observed that:

As a result, audit regulation became a significant new category of financial regulation, joining the well-established categories of banking, insurance and securities regulation.  

1.18 A compelling development arising from the globalisation of capital markets has been the increasing cooperation and coordination between audit regulators across jurisdictions, including the establishment of IFIAR (see paragraph 3.27 below). In this context, a primary consideration in the establishment of cooperative agreements and mutual recognition arrangements is the rigour of the domestic audit regulation framework (including independence from the auditing profession) applying in each jurisdiction.

1.19 Finally, in the context of the global financial crisis and the measures that governments have prescribed as part of the G-20 Action Plan, it is noted that the quality of financial regulation, including the development of global and transparent accounting standards, has moved to centre stage in terms of the remedial action to address the crisis.

1.20 Treasury considers that these regulatory developments, both domestic and international, have shaped and will continue to shape the direction of auditing and audit quality in Australia.

**ADVISORY COMMITTEE ON THE AUDITING PROFESSION TO THE US DEPARTMENT OF THE TREASURY**

1.21 The Advisory Committee on the Auditing Profession (the US Treasury Committee) was established in 2007 to provide informed advice and recommendations to the US Department of the Treasury on the sustainability of a strong and vibrant public company auditing profession.


---


7 Observation by Mr Paul Boyle, Chief Executive, UKFRC and Chairman of IFIAR, in a speech to the European Commission International Auditing Conference, Brussels, on 10 December 2008.

8 Advisory Committee on the Auditing Profession, Final Report, the Department of the Treasury, Washington, 2008, viewed 10 November 2009, <http://www.treas.gov>. The distinguished membership of the Committee included Mr Arthur Levitt (Co-Chair), a former Chairman of the SEC, and Mr Paul Volcker, a former Chairman of the US Federal Reserve System. Mr Mark Olson, former Chairman of the US PCAOB, and Sir David Tweedie, Chairman of the IASB, were appointed as observers to the Committee.
In addressing the sustainability of the auditing profession, the Committee sought input on and considered a number of matters relating directly to auditing firms, including audit quality, governance, transparency, global organisation, financial strength, ability to access capital, the investing public’s understanding of auditors’ responsibilities and communications, the limitations of audits, particularly relating to fraud detection and prevention, as well as the effect of litigation where audits are alleged to have been ineffective. The Committee also considered the regulatory system applicable to auditing firms.9

1.23 Treasury acknowledges that the US Treasury Committee’s Final Report has also informed our strategic review of audit quality in Australia.

THE FUTURE OF AUDITING REPORT

1.24 The report provides a valuable insight into the views of participants in the market for audit services in Australia.

1.25 The following extracts from the report help to explain the research method adopted by its authors:

This research project uses the voices of participants in the market for audit services to explore the current state of the market and gain insights to its future. It uses multiple methods (preliminary focus groups to focus the survey questions and interview protocols, telephone and mail surveys, face-to-face interviews and focus group interviews with more junior auditors) to elicit qualitative evidence of the perceptions of stakeholder representatives.

The responses elicited from participants in interviews, which make up a large part of this report, have been coded and grouped according to themes using a qualitative software analysis tool and reported, along with the survey results, within these themes, grouped according to the category of the stakeholder. The authors provide ‘summaries’ of responses by each category, together with sections on resulting ‘issues and implications’ and ‘concluding remarks’.10

1.26 It is noted that the data collection for the research project predates the global financial crisis and the authors of the report alert readers to this limitation. Treasury, however, agrees with the authors of the report that in many areas, the underlying core issues existed before the financial crisis and will continue to exist beyond the current economic environment.

1.27 The scale of the project is extensive and Treasury is of the view that the report (which is nearly 800 pages long) and its list of conclusions, policy issues and suggestions on actionable items will contribute over time to the public debate on the future of auditing in Australia.

1.28 The insights in the report have assisted Treasury’s consideration of the key drivers of audit quality in Australia, particularly in comparing the Australian experience with that in the UK and US.

INTERNATIONAL PERSPECTIVE OF MAJOR GLOBAL AUDIT FIRMS

1.29 The six largest global audit firm networks released a major paper in November 2006, Global Capital Markets and the Global Economy: A Vision From the CEOs of the International Audit Networks, which contains some important perspectives on a number of the key issues relating to audit quality.

9 ibid., Chapter VII, Firm Structures and Finances, page 1.
10 The Future of Auditing Report, op. cit., page xxvi.
1.30 Treasury has also had regard to the insights in this paper on audit quality when developing our strategic review.

**HOW TREASURY PROPOSES TO USE THE STRATEGIC REVIEW PAPER**

1.31 Treasury proposes to use this strategic review in undertaking its central agency policy advisory role to the Government and in particular, the Treasurer and the Minister for Financial Services, Superannuation and Corporate Law. Treasury also intends to use the paper in its ongoing policy liaison responsibilities on behalf of the Government with other key stakeholders on audit quality, such as ASIC, the Financial Reporting Council (FRC), the Australian Prudential Regulation Authority (APRA), the accounting and auditing standard setters, the major audit firms, the professional accounting bodies and other organisations representing the ‘users’ of financial statements, including industry and shareholder associations.
PART 2: EXECUTIVE SUMMARY —– KEY FINDINGS

OVERVIEW OF AUSTRALIA’S AUDIT REGULATION FRAMEWORK

Australia’s audit regulation framework in the context of audit quality

Key finding 1

Treasury believes that Australia’s audit regulation framework is robust and stable and, as a key driver of audit quality, can be considered to be in line with international best practice.

Key finding 2

Treasury notes that while the EU’s Statutory Audit Directive provides for a seven-year period, the Australian rotation period of five successive years also applies in Canada, the UK and the US and in light of this consistency, the Treasury does not support the proposal that the current requirement should be increased to seven years. This view is reinforced by the fact that the ‘time out’ period in Australia is two years while a more onerous time out period of five years applies in Canada, the UK and the US. Treasury considers that the five-year rotation period with the two-year time out period constitutes an appropriate balance between continuity, the familiarity threat and audit quality.

Treasury proposes to continue to monitor developments on auditor rotation in overseas jurisdictions but does not consider that it would be appropriate for Australia to unilaterally move from a five- to a seven-year rotation period. Such a change should only be considered if similar changes to the existing requirements were to be made in Canada, the UK and the US. Treasury considers that any move to increase the existing five-year rotation period in Australia would raise the question of whether the existing two year time-out period should also be increased.

Key finding 3

While acknowledging that financial reporting and audit requirements apply in a dynamic environment and will require refining from time to time to keep abreast of market developments and regulatory developments in overseas jurisdictions, Treasury does not consider that the overall legislative framework requires any fundamental reform at the present time. In the context of the auditor independence requirements, this includes not making any changes to the present policy approach in relation to auditor-provided non-audit services.

Key finding 4

While the global financial crisis has exposed a number of problems with financial reporting, these are being addressed at the international level, primarily through the International Accounting Standards Board. Australia’s audit regulation framework appears to be functioning effectively during the current uncertain economic conditions.

Key finding 5

Treasury considers that the global financial crisis has highlighted the importance of audit quality in terms of enhancing and maintaining market confidence. Accordingly, Treasury considers that regulators such as ASIC and APRA, and other key stakeholders including the FRC, AUASB and the
professional accounting bodies should continue to monitor future developments resulting from the
global financial crisis that might have an adverse impact on audit quality, with a view to submitting
any appropriate legislative reform proposals to the Government for consideration (also see key
finding 9). Having regard to the international context in which auditing is now practised and the
importance of global consistency in relation to regulatory practice and standard-setting, Treasury also
considers that it will be important that the regulators and other key stakeholders should take account
of new regulatory initiatives relating to audit quality adopted in foreign jurisdictions, where the
impact of the global financial crisis, in many cases, has been more severe than in Australia.

Key finding 6

Treasury supports the action taken by the Auditing and Assurance Standards Board to issue the suite
of Australian Auditing Standards and ASQC 1 *Quality Control for Firms that perform Audits and Reviews
of Financial Reports, Other Financial Information, and Other Assurance Engagements* in clarity format.

**AUDIT REVIEW PROCESSES**

ASIC audit inspection program

Key finding 7

ASIC’s audit inspection program is in line with the methodologies and best practice standards
adopted by audit oversight bodies in the major developed economies. ASIC’s role as an independent
oversight regulator with clear statutory powers is an important feature of the Australian system. The
reliance that the US Public Company Accounting Oversight Board has been prepared to place on the
Australian audit regulation system for purposes of its joint audit inspection process with ASIC is
testament to the high regard it has placed on ASIC’s performance as an independent statutory audit
regulator.

Key finding 8

Treasury proposes, in conjunction with ASIC, to seek the views of key stakeholders on whether
ASIC’s audit inspection reporting model should be brought into line with the reporting models
adopted in Canada, the UK and the US in relation to public reports on individual audit firm
inspections.

Key finding 9

While there have been reported criticisms of the role of auditors in recent corporate failures, these
appear to raise issues relating to an individual auditor’s competence and professional judgment rather
than any systemic problem within the auditing profession. Contravention of the audit requirements
are subject to a range of sanctions which are enforced by ASIC in appropriate cases. Treasury expects
that ASIC’s investigations into recent corporate failures and future ASIC public inspection reports,
covering periods of difficult economic conditions during the economic downturn, are likely to
highlight a number of specific areas where audits generally could be improved, including in relation
to adequate audit documentation.
Professional accounting bodies’ quality reviews

Key finding 10

The quality review programs conducted by each of the three professional accounting bodies perform a valuable role in promoting audit quality and ethical conduct within the audit profession as an important component of the co-regulatory framework in Australia. The professional quality reviews complement the ongoing audit inspection program conducted by ASIC. The completion of the three-year charter of the Audit Quality Review Board (AQRB), will mean that in future, the major audit firms will be subject only to an ASIC inspection (or ASIC/US Public Company Accounting Oversight Board joint inspection) and a quality review conducted by one of the professional accounting bodies, which will result in a reduction in the firms’ compliance burden.

The FRC’s auditor independence function

Key finding 11

The Treasury would like to explore with ASIC and the FRC whether there is any scope to streamline the work of the two bodies in relation to auditor independence in order to eliminate any duplicated effort. While the FRC’s monitoring and policy advisory role in relation to auditor independence was appropriate immediately after the introduction of the comprehensive auditor independence regime under CLERP 9, these requirements have now been bedded down, and it is clear that auditor independence is only one of the key drivers of audit quality. ASIC has developed a wide-ranging Audit Inspection Program which encompasses all aspects of audit quality, including auditor independence. The FRC’s annual Auditor Independence Report is largely based on the annual report that ASIC prepares on its Audit Inspection Program.

There would appear to be two options that should be explored:

• retain the status quo; or

• remove the auditor independence function from the FRC on the basis that its work in this area significantly duplicates the work that ASIC performs in the context of its ongoing Audit Inspection Program.

AUDIT FIRM ARRANGEMENTS AND PROCESSES

The culture within the firm

Key finding 12

There is credible evidence to support Treasury’s view that Australian audit firms generally regard their internal culture as critically important in relation to audit quality. Treasury’s view is supported by the focus of ASIC’s ongoing auditor inspection program, the observations of the AQRB, the conclusions of the FRC’s Banarra report, the emphasis on professional judgment within the auditing standards and the requirements of Auditing Standard ASQC 1 *Quality Control for Firms that perform Audits and Reviews of Financial Reports, Other Financial Information, and Other Assurance Engagements.*
Key finding 13

While Treasury acknowledges the concerns raised that a more compliance-based approach to auditing may affect audit quality, it considers that within the Australian audit regulation framework, there are strong incentives to ensure that audit firms strive for a culture of excellence in relation to audit quality. In this context, we note the emphasis placed on professional judgment and the identification of risk throughout the suite of auditing standards issued by the AUASB, ASIC’s proactive audit inspection program with its focus on audit quality and auditor independence and the requirements of Auditing Standard ASQC 1 Quality Control for Firms that perform Audits and Reviews of Financial Reports, Other Financial Information, and Other Assurance Engagements.

Key finding 14

Treasury proposes to discuss with stakeholders whether they see value in the Corporations Act being amended to require audit firms that undertake an audit for the purposes of the Corporations Act, to publish on their websites an annual transparency report in line with the requirement under the EU’s Statutory Audit Directive and the Quality Control Reports (QCRs) published by the Big 4 audit firms in accordance with the AQRB arrangements. The publication of such reports may also assist in bridging the audit expectations gap. This proposal would bring the Australian audit regulation framework into line with corresponding developments in the EU, the UK and the US.

The skills and personal qualities of audit partners and staff

Key finding 15

Treasury is of the view that stakeholders in Australia would also agree that the skills and personal qualities of audit partners and staff are important key drivers of audit quality. It is generally recognised that auditing is a knowledge-based service where the primary input is the expertise of individual auditors and their staff.

Key finding 16

Treasury considers that the conclusions of the Future of Auditing Report in relation to the development, use and value of industry expertise, client knowledge and business acumen, the personal attributes of audit staff and the attraction, support and retention of staff should be considered by the audit firms, the professional accounting bodies and the universities.

The effectiveness of the audit process

Key finding 17

The ‘true and fair view’ principle and the requirement for the financial report to comply with the accounting standards are appropriately addressed under the Corporations Act.

Key finding 18

Treasury considers that the exercise of professional judgment by auditors rather than the adoption of a ‘tick-a-box’ approach to auditing is adequately provided for under the Australian audit regulation framework.
Key finding 19

Global consistency in the quality of audits is an important policy objective having regard to the increasingly international focus of trade and commerce and the internationalisation of financial markets. Treasury considers that this objective is best promoted at international forums such as the International Forum of Independent Audit Regulators (IFIAR) where ASIC is an active member. The Treasury also promotes the message of global consistency in the quality of audit whenever bilateral, multilateral and regional opportunities arise.

THE RELIABILITY AND USEFULNESS OF AUDITING REPORTING

Auditor communication, expectations gap and standard audit report

Key finding 20

Treasury is of the view that global consistency is a critical goal that must always be borne in mind in considering any changes to the standard audit report. In the Australian context, we consider that it will be essential for the Auditing and Assurance Standards Board (in accordance with the FRC’s strategic direction) to continue to base the Australian Auditing Standards on the standards issued by the International Auditing and Assurance Standards Board (IAASB). The need for global consistency and the maintenance of international best practice underlines the importance of Australia’s continued input to, and participation within, international bodies such as the IAASB, the International Forum of Independent Audit Regulators (IFIAR) and the International Organisation of Securities Commissions (IOSCO).

Key finding 21

Key stakeholders should consider the suggestion of the Future of Auditing Report that a task force be established to examine the competing challenges of comprehensive and technically accurate financial reporting and auditing information, together with the need for understandable disclosures that have genuine utility to the capital market. Treasury notes however, that the scope for any remedial measures may be limited because much of the complexity in financial disclosure reflects the requirements of international accounting standards, and that the standards must have regard to the ever-increasing complexity of financial transactions and the business environment.

Key finding 22

Treasury proposes to encourage focused discussion with key stakeholders including ASIC, the FRC, the Auditing and Assurance Standards Board (AUASB), the major audit firms and the professional accounting bodies on strategies to minimise identified audit expectation gaps. Treasury is of the view that any proposals to change the current standard audit report would need to be subjected to rigorous cost/benefit analysis to ensure that the risks associated with any changes do not negate the potential benefits. In that context, Treasury is concerned that because of the wide disparity between the sophistication of retail and more sophisticated investors in terms of their understanding of financial statements and audit reports, any changes to the standard audit report may have the perverse effect of introducing confusion among some users, leading to a widening of the expectations gap.

Treasury considers that it will be important for stakeholders to explore the possibility of other forms of auditor communication which may make any changes to the standard audit report unnecessary. In particular, Treasury will encourage the audit firms, the professional accounting bodies and other industry bodies such as the Australian Institute of Company Directors (AICD) and the Australian
Shareholders’ Association (ASA) to prepare and widely disseminate educational material explaining the nature and scope of the audit. This material should explain that an audit involves sampling and is risk-focused, with a view to providing reasonable assurance in relation to the integrity of the financial statements rather than an ironclad guarantee. In this context, Treasury also is of the view that consideration should be given to audit firms being required to prepare and publish a transparency report on their websites (see key finding 14).

FACTORS OUTSIDE THE CONTROL OF AUDITORS

Corporate governance and the audit committee

Key finding 23

Audit committees play a critical role in ensuring the integrity of a company’s financial reporting and the audit process, including the independence and objectivity of the external auditor. The audit committee also plays a wider role in ensuring that the company has sound internal financial control systems. Overall, a well-functioning audit committee underpins the assurance that the board of directors gives to shareholders in relation to the company’s financial statements and the audit process.

The ASX Corporate Governance Principles and Recommendations in relation to the structure, composition and responsibilities of the audit committee appear to be in line with international best practice standards.

However, having regard to the important role that the audit committee plays in the good governance of a company, Treasury considers that it would be appropriate to examine whether the requirement for a company listed on the S&P/ASX All Ordinaries Index to establish an audit committee should be included in the Corporations Act rather than the Listing Rules, and whether the existing requirement should be extended to all listed companies. Another related issue that Treasury considers should be examined is whether the mandatory requirement for the top 300 listed companies to comply with the recommendations of the ASX Corporate Governance Council’s Corporate Governance Principles and Recommendations on the composition, operation and responsibility of the audit committee should be applied to all 500 companies listed on the S&P/ASX All Ordinaries Index. Treasury proposes to explore these issues with relevant stakeholders including ASIC, the Australian Institute of Company Directors (AICD) and the ASX.

Treasury notes that a director who is a member of the audit committee is subject to the duties of a director contained in sections 180-184 of the Corporations Act and under the general law, and that the application of these requirements would tend to increase the standard of care and diligence expected of the director having regard to the special responsibilities placed on members of the audit committee by the ASX Corporate Governance Principles.

Treasury also considers that it is important to recognise that the establishment of an audit committee does not diminish the ultimate responsibility of the board of directors to ensure the integrity of the company’s financial reporting and audit process.

Registered company auditors

Key finding 24

Treasury considers that it would be timely, in the light of the development and publication by the International Federation of Accountants (IFAC) of International Education Standards for Professional
Accountants IES 1 to 8, for the professional accounting bodies to review the existing approved competency standard for the purposes of sections 1280 and 1280A of the Corporations Act. This would ensure, once the revised standard had been approved by ASIC, that the approved competency standard was consistent with international best practice.

**Key finding 25**

Treasury proposes to seek the views of stakeholders on two strategies that may assist in addressing the decline in the number of registered company auditors:

- State and Territory governments should consider whether it would be appropriate to ensure that registration as a registered company auditor is not the sole qualification for purposes of eligibility to undertake a statutory audit required under state and territory legislation. This finding is consistent with the views expressed in the 1997 *Review of Requirements for the Registration and Regulation of Company Auditors* at paragraphs 244-245 (a report of a working party of the Ministerial Council for Corporations).

- Consideration could be given to the introduction of simplified financial reporting and audit requirements for smaller companies limited by guarantee (which predominantly have a not-for-profit focus). There are approximately 11,000 companies limited by guarantee. Treasury notes that the Australian Government is currently examining proposals to amend the Corporations Act which would exempt companies limited by guarantee that fell below a threshold set at $250,000 of consolidated revenue and that are not deductible gift recipients, from all financial reporting, directors’ report and auditing requirements under Chapter 2M of the Corporations Act. As a means of reducing audit costs, the proposals also envisage companies limited by guarantee that exceeded the $250,000 threshold of consolidated revenue but have a consolidated revenue of less than $1 million being given the option of having their financial information subject to a ‘review’ rather than an ‘audit’. The review or audit for a company limited by guarantee that fell into such a category could be undertaken by either a registered company auditor or a member of a professional accounting body with a practising certificate.

**Auditor liability**

**Key finding 26**

Australia has introduced a number of measures to address the issue of auditor liability and in terms of international best practice standards can be considered to be at the forefront of reforms in this area.

Treasury proposes to monitor, in consultation with key stakeholders including the audit profession, the impact on auditor liability of the increasing use of class actions in Australia and the role of litigation funders.
PART 3: OVERVIEW OF AUSTRALIA’S AUDIT REGULATION FRAMEWORK

INTRODUCTION

3.1 Entities with financial reporting obligations under the Corporations Act are required to prepare a financial report which includes the entity’s financial statements, notes and directors’ declaration. The report must be prepared in accordance with accounting standards and audited by a registered company auditor in accordance with auditing standards. The report must also be lodged with ASIC and the ASX (where applicable). The independent audit process performs a critical and essential function in bestowing credibility and reliability on financial statements. High-quality audits are recognised as being critical to the operation of well-functioning markets.

3.2 The Corporations Act establishes a comprehensive statutory regime on auditor regulation, including auditor registration requirements, extensive auditor independence requirements and a strong disciplinary framework.

3.3 In 2004, Australia’s auditor regulation framework was significantly strengthened with a number of measures contained in the CLERP 9 Act. These measures included:

• a comprehensive regime on auditor independence established in the Corporations Act, implementing recommendations of the review on Independence of Australian Company Auditors (the Ramsay report) and the relevant recommendations of the HIH Royal Commission (the HIH report);

• strengthening the auditing standards setting process, and providing these standards with the force of law; and

• strengthening ASIC’s role in relation to surveillance and enforcement of the audit process and financial reporting. ASIC has instituted an ongoing audit inspection program that performs a critical role in ensuring that audit firms are complying with their obligations in relation to auditor independence and audit quality.

3.4 In conjunction with the adoption of these measures, Australia also announced that it would adopt International Financial Reporting Standards (IFRS) from 1 January 2005 and that they would have the force of law under the Corporations Act.

3.5 Recent reforms to the auditor regulation framework have enhanced the robustness of the regulatory requirements. For example, ASIC’s audit inspection powers were significantly enhanced by the Australian Securities and Investments Commission Amendment (Audit Inspection) Act 2007 which clarified the scope of ASIC’s audit inspection powers and facilitated ASIC entering into joint audit inspection arrangements with foreign audit oversight regulators.

3.6 The robust legislative framework in the Corporations Act is supplemented by the professional conduct rules applying to members of the three main professional accounting bodies (CPA Australia, The Institute of Chartered Accountants in Australia (ICAA) and the National Institute of Accountants (NIA)). The professional accounting bodies have established an independent ethical standards board,
the Accounting Professional and Ethical Standards Board (APESB), which is responsible for the professional conduct rules applicable to their members.

3.7 The Audit Quality Review Board (AQRB) was established as a not-for-profit company in December 2005. The role of the AQRB was to monitor the processes by which its participating audit firms (the Big 4 audit firms) seek to ensure their compliance with audit standards and legal obligations relating to independence and audit quality. In February 2009 the AQRB completed its three-year charter, and has submitted its final report. In his foreword to the final report (dated December 2008), the Chairman of the AQRB made the following observations about the AQRB’s overarching commitment:

AQRB has played a significant role in assisting in public understanding of the audit role. AQRB’s function has been to inspect and make recommendations for changes and improvements to the quality assurance processes by which the Big 4 accounting firms ensure their compliance with auditing standards and related applicable legislation. The ultimate purpose of course is the enhancement of the audit process and effectiveness of the firms’ audits.\(^\text{11}\)

**AUDITOR INDEPENDENCE**

3.8 Auditor independence is important in the context of audit quality because the independent audit is critical to the credibility and integrity of financial statements. A lack of independence impairs an auditor’s ability to exercise objective audit judgments and affects confidence in the audit process.

3.9 Most of the auditor independence provisions are contained in Division 3 of Part 2M.4 of the Corporations Act. However, the requirements relating to the annual independence declaration and the disclosure requirements relating to non-audit services are contained in Divisions 1 and 3 of Part 2M.3 and the auditor rotation requirements are contained in Division 5 of Part 2M.4.

3.10 The comprehensive statutory regime on auditor independence in the Corporations Act was introduced by the CLERP 9 Act in 2004. These reforms substantially implemented the recommendations of the review of the *Independence of Australian Company Auditors* (the Ramsay report) and some of the relevant recommendations of the HIH Royal Commission.

3.11 The legislative framework of the auditor independence requirements in the Corporations Act includes:

- a general requirement for auditor independence;
- specific auditor independence requirements which contain restrictions on an extensive range of employment and financial relationships between an auditor, and other persons connected to the auditor, and the audit client. The Ramsay report described these specific restrictions as involving ‘core circumstances which, if they exist, necessarily mean that the auditor is not independent’;
- an annual independence declaration by an auditor to be included in the directors’ report;
- a ‘cooling off’ period of two years which applies to partners of an audit firm or directors of an audit company directly involved in the audit of an audit company before they can take up a

directorship or senior management position with the audit client. Following amendments introduced in 2007, the two-year ‘cooling off’ period is now calculated from the date of the last audit in which the former partner or director participated instead of from the date of departure from the firm or audit company;

• based on a recommendation of the HIH Royal Commission, a restriction on more than one former partner of an audit firm or former director of an audit company becoming an officer of an audit client unless the former partner or director left the firm or audit company five or more years ago;

• the lead auditor and review auditor of a listed company being required to rotate after five successive years; and

• a requirement for the auditor of a listed company to attend the company’s AGM, and for shareholders to be able to submit written questions to the auditor concerning the auditor’s report, including the independence of the auditor.

3.12 Australia does not impose a legislative ban on non-audit services. The Ramsay report noted that it had not uncovered any evidence to suggest that there were systemic failures within the accounting profession in complying with the ethical rules for providing non-audit services.

3.13 The regulatory regime in Australia in relation to non-audit services comprises a matrix of requirements in the Corporations Act, the accounting standards, the auditing standards and the professional bodies’ ethical rules:

• Subsection 300(11B) of the Corporations Act provides that the annual directors’ report of a listed company must disclose the fees paid for non-audit services provided by the auditor during the financial year, as well as a description of each service. In addition, the board of directors (in accordance with advice of the audit committee where applicable) is required under subsection 300(11D) to make (i) a statement that they are satisfied that the provision of non-audit services is compatible with the general auditor independence requirement imposed by the Corporations Act, and (ii) an explanation of why those non-audit services do not compromise auditor independence.

• The broad scope of the general auditor independence requirement imposed on auditors under the Corporations Act would apply to any non-audit service arrangement between an audit firm and an audit client. This empowers ASIC to challenge a particular non-audit service arrangement when it considers that the arrangement creates a subjective and/or objective threat to the auditor’s independence.

• The accounting standards also require disclosure by an entity and by a group of details of non-audit services provided to the entity and to the group.12

• APESB is responsible for the Code of Ethics for Professional Accountants (APES 110) which implements the ethical rules adopted by the International Federation of Accountants (the IFAC Code) in relation to non-audit services.13 Australian Auditing Standard ASA 102 Compliance with Ethical Requirements when Performing Audits, Reviews and Other Assurance Engagements requires an auditor to comply with relevant ethical requirements. Paragraph A1 of Application and Other Explanatory Material in ASA 102 provides that an auditor is to have regard to the applicable

requirements of APES 110, which are to be taken into account in determining whether relevant ethical requirements have been met.\textsuperscript{14}

3.14 APES 110 recognises that non-audit services may create threats to the audit firm’s independence and requires auditors to evaluate the significance of any threat created by the provision of such services. APES 110 provides that in some cases it may be possible to eliminate or reduce the threat created by the application of safeguards. In other cases, no safeguards may be available to reduce the threat to an acceptable level, and if this is the case, APES 110 requires either the audit services or the non-audit services to be refused.\textsuperscript{15}

3.15 The Future of Auditing Report focuses on two facets of auditor independence: auditor-provided non-audit services and audit partner rotation.\textsuperscript{16}

- The views of interviewees on whether a higher level of prohibition on the provision of non-audit services would bring desired benefits in independence were mixed.\textsuperscript{17} It would appear that a majority of interviewees did not see a need for the existing requirements to be tightened, and one interviewee expressly opposed the introduction of a blanket ban on the provision of non-audit services. Treasury does not consider that any persuasive case has been made out to change the existing matrix of requirements in Australia in relation to the provision of non-audit services.

- There were a diverse range of views among interviewees on the merits or otherwise of auditor rotation. While many interviewees indicated that they agreed with audit partner rotation in principle, concerns were expressed that the five-year rotation period was insufficient to build up adequate knowledge of the client. The report concluded that ‘on balance, by examining the arguments for and against, it would seem that organisations that are large in size or are particularly complex or operate in a highly regulated and therefore complex industry are those that might command longer periods of audit tenure compared with other organisations’.

- Treasury notes that while the EU’s Statutory Audit Directive provides for a seven-year period, Australia’s rotation period of five years is in line with the corresponding rotation period applying in Canada, the UK and the US (under the SEC rules).\textsuperscript{18} Furthermore, while Australia has adopted a two-year period before a ‘rotated’ partner is permitted to resume involvement with the same audit client, Canada, the UK and the US (through its SEC rules) have all adopted a more onerous five-year time-out period. Treasury considers that any move to increase the existing five-year rotation period in Australia, would of necessity require consideration of whether the existing two-year time-out period should also be increased. It may also be difficult to justify any changes to the existing requirements in the absence of data on the career paths of audit partners who have been rotated off a particular audit.

- Some of the ‘supplier’ interviewees in the Future of Auditing study were critical of the scope of the financial investment restrictions applying to partners in an audit firm. Treasury notes that this issue was addressed in the 2007 amendments to the auditor independence requirements in the Corporations Act, so that the financial restrictions no longer apply to all partners in the firm but only to a partner who is involved in the particular audit or is in a position to influence the outcome of the audit.

\textsuperscript{14} op.cit., n. 6.
\textsuperscript{15} ibid., paragraph 290.158.
\textsuperscript{16} Future of Auditing Report, op. cit., page 347.
\textsuperscript{17} ibid., see discussion pages 350-374.
\textsuperscript{18} While the UK has retained the five-year rotation period for the audit engagement partner in relation to audits of listed companies, the Auditing Practices Board has revised the relevant ethical standard to allow audit committees to extend the rotation period from five to seven years in certain circumstances for periods commencing from 15 December 2009.
3.16 The Auditing Practices Board (APB), one of the UKFRC’s operating bodies, issued a consultation paper on 6 October 2009 seeking views from stakeholders, especially investors, on whether investor confidence would be enhanced by a prohibition on audit firms conducting non-audit services for an audit client. Treasury proposes to monitor the outcome of the APB’s consultation process.

COMPARATIVE REVIEW OF AUSTRALIA’S AUDITOR INDEPENDENCE REQUIREMENTS

3.17 The Treasury prepared a discussion paper Australian Auditor Independence Requirements: A Comparative Review which was released on 15 November 2006. The overall conclusion of the comparative review was that, despite differences in terminology, institutional arrangements and legal frameworks, there is a substantial underlying equivalence between the Australian requirements and international best practice standards.

3.18 The comparative review has been particularly useful in informing discussions between Treasury and key stakeholders in the context of refinements made in 2007 to the auditor independence rules.

AUSTRALIAN QUALITY CONTROL STANDARDS

3.19 The Auditing and Assurance Standards Board (AUASB) was established by the CLERP 9 Act as an independent statutory body under section 227A of the Australian Securities and Investments Commission Act 2001 (ASIC Act). Under section 336 of the Corporations Act, the AUASB may make Auditing Standards for the purposes of the corporations legislation. The Australian Auditing Standards (ASAs) made by the AUASB are legally enforceable legislative instruments under the Legislative Instruments Act 2003.

3.20 One of the AUASB’s statutory functions set out in paragraph 227B(1)(d) of the ASIC Act is to ‘participate in and contribute to the development of a single set of auditing standards for world-wide use’. The AUASB has, wherever possible, used International Standards on Auditing (ISAs) issued by the International Auditing and Assurance Standards Board (IAASB) as a base for its Auditing Standards, in order to achieve conformity with international auditing standards.

3.21 The AUASB has progressively reviewed the ASAs to improve quality, clarity and presentation (the Clarity Project) and the review has been impacted by the development of the IAASB’s ‘Clarity of IAASB Standards’ project as well as other international standard setting activities. The AUASB’s Clarity Project is in line with the strategic direction given to the AUASB by the FRC, in terms of which the AUASB is required to have regard to any program initiated by the IAASB for the revision and enhancement of the auditing standards. Treasury also considers that the AUASB’s Clarity Project is

---

19 Consultation on Audit Firms Providing Non-Audit Services to Listed Companies that they Audit, Auditing Practices Board, London, 2009, viewed 11 November 2009, <http://www.frc.org.au/apb>. The consultation is in response to a UK Treasury Select Committee report entitled ‘Banking Crisis: reforming corporate governance and pay in the City’ which called for the appropriateness of the provision of non-audit services by audit firms to their audit clients to be revisited.


consistent with its statutory obligation under paragraph 227B(1)(d) to participate in and contribute to the development of a single set of auditing standards for world-wide use.

3.22 The AUASB approved the suite of standards revised and redrafted in clarity format on 27 October 2009. These standards apply to audits of financial statements and financial reports for financial periods commencing 1 January 2010 (but note operative date of ASQC 1 — see below).

3.23 While all the ASAs are relevant to audit quality, it is important to note, in the context of Treasury’s strategic review of audit quality, ASA 220 Quality Control for Audits of Historical Financial Information which is the Australian equivalent of ISA 220 Quality Control of Audits of Historical Financial Information. ASA 220 establishes mandatory requirements and provides explanatory guidance on specific responsibilities of firm personnel regarding quality control procedures for an audit of a financial report.

3.24 The AUASB also approved, on 27 October 2009, ASQC 1 Quality Control for Firms that Perform Audits and Review of Financial Reports, Other Financial Information and Other Assurance Engagements which is based on the clarity version of International Standard on Quality Control (ISQC) 1 Quality Control for Firms that perform Audits and Reviews of Historical Financial Information and other Assurance and Related Services Engagements issued by the IIAASB. ASQC 1 requires firms to establish internal systems of quality control by 1 January 2010. ASA 220 and ASQC 1 relating to audit quality at the engagement level (ASA 220) and at the firm level (ASQC 1) are intrinsically linked.

3.25 Treasury supports the action taken by the AUASB to issue the suite of ASAs and ASQC 1 in clarity format.

AUSTRALIA’S AUDIT REGULATION FRAMEWORK AND MARKET BEHAVIOUR

3.26 The passage of the Corporations Legislation Amendment (Simpler Regulatory System) Act 2007 in June 2007 signalled the completion of the ‘bedding down’ of the major auditor regulation reforms which were introduced by the CLERP 9 Act in 2004. Five years after the CLERP 9 Act commenced, there is substantial evidence that the audit reforms have had a positive transformative effect on market behaviour within the audit profession.

• The FRC’s overall conclusion in its 2006-07 Report on Auditor Independence is that the independence framework continues to operate effectively and that no systemic issues were identified. The FRC confirmed this conclusion in its 2008-09 Annual Report.

• The auditing profession has undergone a significant cultural transformation from being a largely self-regulated profession to one that is now subject to an independent audit oversight regulator in Australia and in most overseas developed economies. The positive effects of this development on market behaviour are manifest. The major audit firms have invested heavily in new technology and training, resulting in a substantial enhancement of their pools of expertise in relation to auditor independence, audit quality and risk management.

• The AQRB, in its report on 2006 reviews, made positive observations in relation to the commitment of the Big 4 audit firms to audit quality and independence:

Another area of significant focus for AQRB was the extent to which firms have embedded audit quality within their culture. We noted that all firms have placed a strong emphasis on audit quality in the messages from their leadership to partners and staff.
No other area of the firms’ activities has received more attention, both internal and external, than their processes for ensuring that they remain properly independent of their audit clients and compliant with the law and professional standards.

- In the AQRB’s Third Report released in February 2009, the Chairman’s Foreword contained the following pertinent observations:

  It is in this context that it is appropriate to record that AQRB has observed that in the last 3 years the Big 4 accounting firms in Australia have worked assiduously to improve their audit quality and risk management processes. They have also displayed a welcome willingness to open up their internal processes to public scrutiny so as to provide investors with a better understanding of how they manage their audit activities. In particular, and of special interest to AQRB, their Quality Control Reports (which may be viewed at www.aqrb.org.au) describe how they seek to ensure the highest quality in their work through careful client acceptance procedures, selection of well qualified audit teams, use of comprehensive and tailored audit programmes, review by independent partners and firm-wide monitoring programmes.22

- ASIC’s Audit Inspection Program Public Report for 2006-07 has made the following relevant general observations:

  Australia has a skilled audit profession committed to independence and audit quality. Firms generally have robust systems and processes in place that are designed to ensure compliance with auditor independence requirements and the conduct of quality audits. Our inspections in Year 3 observed that the quality of auditing in Australia is fundamentally sound.23

  The Firms have responded positively to the Australian legislative requirements for auditor independence and audit quality. Many Firms have committed, and continue to commit, dedicated technical resources and, where required, have developed or further enhanced existing policies and systems to assist them in complying with legislative requirements.24

- ASIC has noted that its review of the 31 December 2008 financial reports did not reveal any significant non-compliance with the financial reporting obligations.25

AUSTRALIA’S AUDIT REGULATION FRAMEWORK AND MUTUAL RECOGNITION ARRANGEMENTS WITH OVERSEAS AUDIT AUTHORITIES

3.27 ASIC has participated actively at the international level on audit issues through its membership of the International Organisation of Securities Commissions (IOSCO) and the International Forum of Independent Audit Regulators (IFIAR). IFIAR was established in 2006 to foster the sharing of practical experiences in audit oversight, to help reduce inefficiencies and costs, and to promote best practice in the audit oversight function. The then Chairman of ASIC, Mr Jeffrey Lucy AM, was appointed as the inaugural Chairman of IFIAR which provided ASIC with the opportunity to lead discussion amongst global audit regulators in relation to domestic and international audit issues.

24 ibid., page 6.
Closer international cooperation by ASIC with overseas regulators is in Australia’s national interest because of the globalisation of capital markets. Australia’s robust audit regulation system has been recognised by overseas regulators for purposes of mutual recognition arrangements:

- ASIC entered into a cooperative audit oversight arrangement in 2007 with the US Public Company Accounting Oversight Board (PCAOB) which provides for ASIC and the PCAOB to undertake joint audit inspections of Australian audit firms registered in the US, resulting in significant cost savings for the audit firms. ASIC has advised the Government that from ASIC’s perspective, the cooperative arrangement with the PCAOB has been extremely effective and successful.

- Pursuant to the US Sarbanes-Oxley Act, the PCAOB is charged with the oversight of public accounting firms that provide audit services to US public companies regardless of where the firms are domiciled. As at 3 December 2009, 41 Australian accounting firms were listed as having registered with the PCAOB. PCAOB Rule 4012 permits the PCAOB to rely on independent audit oversight bodies located in the home countries of registered non-US audit firms in connection with required inspections. The framework contained in Rule 4012 is based on a sliding scale: the more independent and rigorous the home-country oversight system, the greater the PCAOB’s reliance on that system. The rule is based on five principles that the PCAOB has developed to guide its evaluation of the independence and rigour of the home-country system. The five principles on which Rule 4012 is based are (1) the adequacy and integrity of the oversight system, (2) the independence of the system’s operation from the auditing profession, (3) the independence of the system’s source of funding, (4) the transparency of the system and (5) the system’s historical performance.

- On 5 December 2007, the PCAOB issued for public comment a proposed Policy Statement that identifies the factors relevant to ‘full reliance’ by the PCAOB on the inspection systems of its non-US audit oversight bodies. Full reliance means, in general, that the PCAOB will rely upon a non-US oversight body to plan the inspection, carry out the inspection fieldwork and make findings based on its fieldwork. The proposed Policy Statement articulates certain essential criteria that further define the five principles set forth in Rule 4012. Treasury understands that the PCAOB is still evaluating public comment on the proposed Policy Statement before deciding on its adoption.

- Subsection 11(10) of the ASIC Act empowers ASIC, with the consent of the Minister, to enter into cooperative audit oversight arrangements with foreign audit regulators (this power was granted to ASIC under the Australian Securities and Investments Commission Amendment (Audit Inspection) Act 2007).

- The EU’s Directive on Statutory Audit requires an audit firm that audits the annual or consolidated accounts of a company incorporated in a third country whose transferable securities are admitted to trading on a regulated market in a EU Member State, to register in that Member State and to be subject to the system of auditor oversight in that Member State (including audit inspections). Articles 45 and 46 of the directive, however, provide that a Member State may exempt (wholly or partially) a third country audit firm from these requirements if the third party audit firm is subject to equivalent systems of public oversight, quality assurance, investigations and penalties. The directive came into effect on 29 June 2008.

The EU Commission is currently carrying out equivalence assessments on third country audit regulation systems. While this assessment process is being undertaken, the EU Commission has granted transitional measures to audit firms in certain third countries (including Australia) to continue their activities. The transitional measures provide that an audit firm in such a third country is not required to register with the audit oversight authority in a particular Member State on condition that the audit firm provides the authority with information about the firm and the auditor independence requirements and auditing standards applying to the firm. The transitional measures apply until 1 July 2010. Treasury understands that there are a number of Australian companies that have transferable securities listed on regulated exchanges in EU-regulated markets, particularly in the UK and Germany, and that accordingly, Australian auditors of these companies would be required to comply with the directive.

The EU Commission is currently liaising with ASIC in connection with the EU Commission’s final equivalence decision in relation to Australia’s audit regulation framework. The final decision of the EU Commission is expected to be made during 2010. ASIC liaises regularly with Treasury in relation to the EU Commission’s equivalence process.

- Japan has introduced a comprehensive audit oversight regime including audit inspections. Non-Japanese audit firms which audit entities listed in Japan are required to register with the Japanese authorities and are subject to Japan’s auditor oversight systems. Treasury understands that three Australian audit firms either have registered or are in the process of registering with the Japanese authorities. The Japanese authorities (the Financial Services Agency and the Certified Public Accountants and Auditing Oversight Board) have commenced preliminary discussions with ASIC seeking to strengthen audit oversight cooperation between ASIC and the Japanese authorities.

THE GLOBAL FINANCIAL CRISIS: ACCOUNTING AND AUDITING ISSUES

3.29 The Australian Government, regulatory agencies and the independent accounting and auditing standard setters have been active in responding to a range of accounting and auditing issues arising from the global financial crisis and the general uncertain economic conditions.

G-20 Action Plan: accounting standards

3.30 At the international level, Australia is heavily involved in the implementation of the G-20 Action Plan. Australia was invited to nominate an additional representative on the Financial Stability Board (FSB) Plenary. This seat has been filled by a senior Treasury official.

3.31 To ensure the timely progress of implementation of the G-20 recommendations and that Australia is active in shaping the international agenda through the FSB and other bodies, the Treasurer requested Treasury to convene a G-20 Reform Implementation Committee within Australia. The Committee’s role is to coordinate the Government’s response to the financial regulatory items in the G-20 London Summit declaration and to ensure that Australia takes a leadership role in implementing the G-20 agenda. The key mandates of the Committee are to:

- assist in developing an Australian position in key policy areas and ensure that Australia influences the international debate and the development of international standards;

- ensure timely, coordinated and proactive planning for Australia’s domestic implementation of appropriate G-20 recommendations;
• report to government on developments in international forums and progress on G-20 action items, particularly ahead of international discussions.

3.32 In light of the important focus that the G-20 has given to accounting standards, the Treasury has involved the FRC and the Australian Accounting Standards Board (AASB) in the Committee’s processes where required.

3.33 There have been a number of significant developments relating to accounting standards at the international level. The G-20 has requested that the two global accounting standard setters, the International Accounting Standards Board (IASB) based in London and the US Financial Accounting Standards Board (FASB), address a range of accounting issues that have arisen during the global financial crisis. These issues include fair value measurement, the simplification of the standard relating to financial instruments, the treatment of off-balance sheet exposures and enhanced disclosure of complex financial products. The G-20 has also urged the IASB and FASB to work towards a single set of global accounting standards. On 24 February 2010, the US Securities and Exchange Commission issued a statement supporting a single set of high quality globally accepted accounting standards.28

3.34 Treasury considers that it will be important to ensure that the IAASB is brought into the discussion on the development of new standards by the IASB and FASB so that the IAASB is fully apprised at the development stage of any auditing issues that are likely to arise from the adoption of revised accounting standards.

**Auditing issues in uncertain economic times**

3.35 ASIC and the AUASB have been proactive in highlighting a number of areas on which directors and auditors need to focus in the current economic environment.

3.36 In its media release ‘ASIC Review of 30 June 2009 Financial Reports’ issued on 26 June 2009, ASIC noted that its review of the 31 December 2008 financial reports did not reveal any significant non-compliance with the financial reporting obligations.29 However, ASIC emphasised that directors and auditors should continue to focus on specific areas most affected by the current economic conditions. Some of the key areas identified by ASIC included going concern, asset impairment, fair value determinations, off-balance sheet arrangements and financial instrument disclosures.

3.37 The AUASB issued a Bulletin, *Auditing Considerations in an Uncertain Economic Environment*, on 30 April 2009 to assist auditors in considering how to deal with the greater risks presented by an uncertain or difficult economic environment.30

3.38 The AUASB has also collaborated with the Australian Institute of Company Directors (AICD) in the preparation of a publication, *Going Concern* (released on 1 June 2009), which explains the concept of ‘going concern’ and aims to assist company directors in understanding and carrying out their responsibilities in relation to the going concern assessment that must be made in relation to the preparation of a company’s financial report.31

---

29 Australian Securities and Investments Commission, op. cit., n. 22.
3.39 In its overarching comments, the Future of Auditing Report made the following pertinent observations:

With the onset of the global financial crisis, now more than ever the operation of the capital market has been put under pressure. A key objective of this research project is to make observations that might enhance and support the efficiency of the capital market through the information provided by auditors and its impact and influence. At the time of writing, there have been few negative observations about auditors and their role in the global financial crisis (GFC). While criticisms of bankers, regulators, directors and senior executives, advisory firms, hedge funds and other financial service organisations (among other) mount, little concern has been expressed about the role of audit. To some, this could be unexpected, but the presence of no news is to the eyes of some ‘good news’. In some ways, the GFC can be seen as a stress test of audit where the stress has not resulted in structural failure.32

3.40 The Basel Committee has stated that the need for bank supervisors to be confident of audit quality remains one of the keys to effective banking supervision and warrants the continued involvement by the Committee to support audit quality. The Basel Committee has recognised the role that audit quality plays in enhancing market confidence:

The current market turmoil and demand for increased transparency suggests that reliable, clear financial information supported by quality audits are key elements in enhancing market confidence.33

3.41 The Basel Committee has also explained how quality audits enhance market confidence, particularly in times of severe market stress:

External audits performed in accordance with high quality auditing and ethics standards are an important element of enhancing market confidence. This is particularly the case with respect to valuations of financial instruments, including disclosures about the valuation methodologies, and the extent of off-balance sheet risks to which banks are exposed. The current market turmoil has shown the fundamental role that external auditors play in shaping financial reporting practice.34

FINDINGS: AUSTRALIA’S AUDIT REGULATION FRAMEWORK IN THE CONTEXT OF AUDIT QUALITY

Key finding 1
Treasury believes that Australia’s audit regulation framework is robust and stable and, as a key driver of audit quality, can be considered to be in line with international best practice.

Key finding 2
Treasury notes that while the EU’s Statutory Audit Directive provides for a seven-year period, the Australian rotation period of five successive years also applies in Canada, the UK and the US and in light of this consistency, the Treasury does not support the proposal that the current requirement should be increased to seven years. This view is reinforced by the fact that the time-out period in

32 See the Future of Auditing Report, op. cit., page xvii.
33 External audit quality and banking supervision, op. cit., n. 2, page 1.
34 ibid., page 5.
Australia is two years while a more onerous time-out period of five years applies in Canada, the UK and the US. Treasury considers that the five-year rotation period with the two-year time-out period constitutes an appropriate balance between continuity, the familiarity threat and audit quality.

Treasury proposes to continue to monitor developments on auditor rotation in overseas jurisdictions but does not consider that it would be appropriate for Australia to unilaterally move from a five- to a seven-year rotation period. Such a change should only be considered if similar changes to the existing requirements were to be made in Canada, the UK and the US. Treasury considers that any move to increase the existing five-year rotation period in Australia, would raise the question of whether the existing two-year time-out period should also be increased.

**Key finding 3**

While acknowledging that financial reporting and audit requirements apply in a dynamic environment and will require refining from time to time to keep abreast of market developments and regulatory developments in overseas jurisdictions, Treasury does not consider that the overall legislative framework requires any fundamental reform at the present time. In the context of the auditor independence requirements, this includes not making any changes to the present policy approach in relation to auditor-provided non-audit services.

**Key finding 4**

While the global financial crisis has exposed a number of problems with financial reporting, these are being addressed at the international level, primarily through the International Accounting Standards Board. Australia’s audit regulation framework appears to be functioning effectively during the current uncertain economic conditions.

**Key finding 5**

Treasury considers that the global financial crisis has highlighted the importance of audit quality in terms of enhancing and maintaining market confidence. Accordingly, Treasury considers that regulators such as ASIC and APRA, and other key stakeholders including the FRC, AUASB and the professional accounting bodies should continue to monitor future developments resulting from the global financial crisis that might have an adverse impact on audit quality, with a view to submitting any appropriate legislative reform proposals to the Government for consideration (also see key finding 9). Having regard to the international context in which auditing is now practised and the importance of global consistency in relation to regulatory practice and standard-setting, Treasury also considers that it will be important that the regulators and other key stakeholders should take account of new regulatory initiatives relating to audit quality adopted in foreign jurisdictions, where the impact of the global financial crisis, in many cases, has been more severe than in Australia.

**Key finding 6**

Treasury supports the action taken by the Auditing and Assurance Standards Board to issue the suite of Australian Auditing Standards and ASQC 1 Quality Control for Firms that perform Audits and Reviews of Financial Reports, Other Financial Information, and Other Assurance Engagements in clarity format.
PART 4: AUDIT REVIEW PROCESSES

ASIC AUDIT INSPECTION PROGRAM

4.1 ASIC is the key regulator under the Corporations Act and has responsibility for the surveillance, investigation and enforcement of the financial reporting requirements of the Corporations Act, including the enforcement of auditor independence and audit quality requirements. The scope of ASIC’s audit inspection powers was enhanced by the Australian Securities and Investments Commission Amendment (Audit Inspection) Act 2007. The amendments introduced by this Act ensured that ASIC’s audit inspection and information-gathering powers were brought into line with corresponding powers granted to key overseas audit regulators.

4.2 ASIC commenced its ongoing audit inspection program in 2005. In that year it inspected the Big 4 firms. In subsequent years, ASIC continued to inspect the Big 4 firms but also began inspecting second-tier firms and smaller firms. In 2007, ASIC inspected 19 firms, of which nine were inspected for the first time, six were inspected for the second time (being the six second-tier firms inspected in 2006) and four were inspected for the third time (that is, the Big 4). As part of the 2007 audit inspection program, ASIC reviewed 101 audit engagements. ASIC also began conducting joint inspections with the PCAOB. Since signing their cooperative arrangement, ASIC and the PCAOB have conducted five joint inspections of Australian audit firms.

4.3 ASIC focuses on audit quality by promoting compliance with the requirements of the Corporations Act, Australian Auditing Standards and professional and ethical standards. ASIC’s inspection program is designed to:

• confirm ASIC’s understanding of the design of each audit firm’s system of quality control. It covers the following elements of quality control as set out in ASA 220 Quality Control for Audits of Historical Financial Information and ASQC 1 Quality Control for Firms that perform Audits and Reviews of Financial Reports, Other Financial Information, and Other Assurance Engagements:

  – leadership responsibilities for quality within the firm (executive leadership/tone at the top);
  – ethical requirements (independence);
  – acceptance and continuance of client relationships and specific engagements;
  – human resources;
  – engagement performance (audit quality); and
  – monitoring;

• test the effectiveness of the implementation of each firm’s system of quality control that provides reasonable assurance that:

---

35 Prior to the application of ASQC 1 from 1 January 2010, the applicable standard was APES 320 Quality Control of Firms issued by the Accounting Professional and Ethical Standards Board.
the firm complies with the audit independence requirements in Division 3 of Part 2M.4 of the Corporations Act (independence); and

the firm’s audit methodology facilitates the conduct of its audits in accordance with the auditing standards as required in Division 3 of Part 2M.3 of the Corporations Act (audit quality).

4.4 After each inspection, ASIC issues the firm with a confidential inspection report and the firm responds as to how it will deal with the issues which ASIC has identified. ASIC then revisits the firm, generally after around 12 months, to gauge the extent to which the firm has taken remedial action. In accordance with a Memorandum of Understanding between ASIC and the FRC, ASIC provides the FRC, for the purposes of the FRC’s auditor independence function, with a generic report on its audit inspection program for the previous period, particularly noting any systemic issues identified. ASIC’s usual practice is to issue each year on the ASIC website, a public report which sets out key themes and issues identified by ASIC’s audit inspection program during the preceding inspection period (which may be up to 15 months).

4.5 By working with the profession, ASIC has assisted in raising the standard of audit quality and auditor independence. ASIC has noted the following improvements as a result of its supervisory activities:

- creation of quality control policies and procedures;
- employment of dedicated technical resources;
- employment of external experts to conduct monitoring activities;
- changes of auditor in relation to a small number of listed audit clients; and
- registration by partners on specified training courses.

4.6 Although there is no legal obligation to report publicly, ASIC issues public reports on systemic themes and issues identified during the audit firm inspections. These public reports are prepared on an aggregated basis across firms and are intended to inform stakeholders of key themes and issues with the objective of contributing to better audit quality by all firms. These public reports do not attribute specific matters to any firm or audit client of a firm.

4.7 ASIC has indicated in its Audit Inspection Program Public Report for 2006-07 that its future focus will build on the results of earlier inspection programs and will include how firms are complying with legally enforceable auditing standards, particularly ASA 230 Audit Documentation. Other specific areas of focus will include technical consultations, using the work of experts, particularly in relation to fair value measurements, sectors that are at risk in the current market turbulence, and using the work of other auditors.36

4.8 Treasury notes that in a number of important overseas jurisdictions, the independent audit regulator is permitted to make public disclosure about defects in an individual audit firm’s quality control systems, subject to appropriate natural justice protections.

- In the US, the PCAOB is required by the Sarbanes-Oxley Act to produce public inspection reports, although portions of the complete report are omitted to comply with confidentiality requirements in the Act. The Sarbanes-Oxley Act provides a framework for a remedial process whereby firms

---

have 12 months to remedy defects in their quality control systems to prevent these defects being made public.

- In the UK, the Audit Inspection Unit (AIU), part of the Professional Oversight Board, issues a confidential report to the audit firm inspected. In addition to the confidential report, the AIU publishes both an annual overview report on its audit inspection activities and a high level public report on the inspection of an individual audit firm, detailing findings from reviews of individual audits (without client names) concerning failures to comply with auditing standards or good practice. Criticism (if relevant) of the audit firm’s quality control policies and procedures is also made public. Specific reports are also issued to engagement partners of deficiencies in the file reviewed with an expectation that this is shared with the relevant client audit committee or board of directors.

- In Canada, the Canadian Public Accountability Board (CPAB), produces private reports of findings and recommendations to the individual firms inspected. Failure to implement one or more recommendations to CPAB’s satisfaction within a prescribed timeframe (generally six months) may result in CPAB making public the relevant portions of the inspection report.

4.9 The underlying policy rationale for the individual firm public reporting models in Canada, the UK and the US, is to improve confidence in the capital markets through increased transparency in the audit process. Furthermore, where the reporting model provides the opportunity for an audit firm to correct weaknesses identified in the private confidential report, coupled with the possibility of public disclosure for any failure to take remedial action, it provides a strong incentive for an audit firm to make prompt improvements in overall audit quality.

4.10 In Australia, section 127 of the ASIC Act prevents ASIC from issuing public individual firm reports without the consent of the audit firm concerned.

4.11 Treasury proposes, in conjunction with ASIC, to engage with key stakeholders as to whether ASIC’s existing audit inspection reporting model should be brought more into line with the approach in Canada, the UK and the US. In this context, the Treasury would like to explore with stakeholders the following issues:

- the costs and benefits of introducing a reporting model which would enable ASIC to issue public individual audit firm reports, without a firm’s consent, but subject to appropriate natural justice protections which would include remedial opportunities with ASIC prior to release of public information by ASIC;

- the costs and benefits of a process which would require audit firms to communicate significant matters identified by ASIC in its confidential audit inspection report to a firm to the audit client’s audit committee and/or board of directors; and

- the scope of any amendments required to the ASIC Act, including section 127, to achieve an appropriate public individual firm reporting model.

PROFESSIONAL ACCOUNTING BODIES QUALITY REVIEWS

4.12 The professional accounting bodies (CPA Australia, the ICAA and the NIA) undertake regular mandatory quality reviews of members who have a Certificate of Public Practice (CPP) or Public Practice Certificate (PPC). The reviews include ensuring their members are complying with the accounting, auditing and assurance standards and the code of ethics issued by the APESB. The reviews take place on a rolling three-year program for auditors of listed entities.
4.13 The ICAA’s Annual Report on the Quality Review Program for the year ended 30 June 2009 provides a snapshot of the scope of the quality review programs undertaken by the professional accounting bodies.37

- The ICAA’s Program is a quality assurance process to monitor whether its members have the quality control policies and procedures in place to comply with professional standards and legal requirements. The program is compliance-focused. Reviews do not assess the appropriateness of the opinions issued, or the advice provided, by members.

- This was the first financial year where all audits under review were subject to the enhanced and legally enforceable auditing standards.

- The ICAA completed 468 quality reviews during the financial year ended 30 June 2009, ranging in size from national partnerships to sole practitioners.

- Once a review has been completed, the ICAA issues a report to the practice, where any areas of concern are highlighted and the firm is asked to address these concerns. The ICAA will then follow up its report to ensure that its members have taken the necessary steps to put matters right. In a small number of cases of non-compliance, the ICAA refers members for disciplinary investigation and possible sanctions.

  - Of the reviews completed, 79 per cent of practices were reported to have either met all of the professional standards and regulatory requirements as set by standard setters and regulators, or showed levels of non-compliance that were not regarded as serious.

  - In the remaining 21 per cent of practices, the ICAA found more significant areas of non-compliance which meant that it had to conduct a follow-up review. This allows the ICAA to revisit the practice and ensure that all issues identified have been rectified.

  - During reviews, 5 per cent of practices decided to cease conducting audit engagements as they recognised that auditing is an advanced technical skill and either were not equipped to meet the requirements of the current auditing standards or could not commit the resources required to do so within a reasonable timeframe.

- All practices that sign off on audits requiring a registered company auditor (RCA) registration are reviewed at least once every three years. All other practices are reviewed once every five years, including practices with an RCA but not conducting RCA audits.

4.14 The quality review programs of the three professional accounting bodies perform a significant and valuable role within Australia’s overall audit regulation framework in promoting audit quality and ethical conduct within the auditing profession. The self-regulatory function undertaken by the professional accounting bodies plays an important role in supplementing ASIC’s statutory responsibilities as the key audit oversight regulator. The following examples illustrate the positive contributions made by the professional bodies in this context:

- The quality reviews are undertaken in a rigorous and systematic manner. For example, the ICAA was transparent in publicly highlighting the following concerns in relation to the 2009 Quality Review Program:

  - insufficient audit documentation;

inadequate documentation of quality control in accordance with APES 320: Quality Control for Firms;

not meeting the minimum required hours of training and development, mainly in respect of their statutory registration;

as part of its response to these auditing compliance issues, the ICAA has undertaken remedial action including the launch of an audit manual and toolkit, together with supporting training events for its members.38

• The three professional bodies jointly issued a revised version of their Independence Guide: Interpretations in a Co-regulatory Environment in June 2008. The guide is intended to provide a clear indication of the conceptual approach adopted in Section 290 of APES 110 Code of Ethics, with practical examples of independence issues encountered by accountants and auditors.

• In March 2009 the ICAA published an updated version of its Quality Control Guide for its members. The guide was produced in response to requests from many smaller firms for assistance with quality control.

• In November 2009 the ICAA published The benefit of audit: A guide to audit quality. The purpose of this guide is to enhance communication between the audit committee and the external auditor.

• The three professional accounting bodies provide comprehensive programs of training and guidance to facilitate continuing professional development and to assist in compliance with legislative requirements and professional standards.

THE ROLE OF THE AQRB

4.15 The role of the AQRB was to monitor participating audit firms (the Big 4 audit firms) that audit publicly listed companies, to assess whether they comply with professional standards and the law. The ARQB Chairman has described the role of the AQRB, in contrast to ASIC’s statutory responsibilities, as ‘more akin to an honest and frank conversation with the participating firms about their own policies, systems and practices, with the aim to ensure that the audit function is carried out at the highest standards’.

4.16 As noted above, the AQRB has completed its three-year charter and submitted its final report dated December 2008.

THE FRC’S AUDITOR INDEPENDENCE FUNCTION

4.17 The FRC has been given specific functions concerning quality assurance reviews in relation to auditor independence. Under subsection 225(2B) of the ASIC Act, the FRC’s functions include monitoring and assessing the nature and overall adequacy of:

• the systems and processes used by professional accounting bodies for planning and performing quality assurance reviews of audit work undertaken by Australian auditors, to the extent those reviews relate to auditor independence requirements;
• the action that Australian auditors who have been the subject to such quality assurance reviews have taken in response to the reports prepared as a result of those reviews; and

• the action taken by professional accounting bodies to ensure that Australian auditors who have been subject to such quality assurance reviews respond appropriately to the reports prepared as a result of those reviews.

4.18 The FRC is responsible for giving the Minister and the professional accounting bodies reports and advice about these matters.

4.19 In its Report on Auditor Independence 2006-07, the FRC encouraged ASIC, the AQRB and the professional accounting bodies to continue to work together to streamline their review processes and reduce the regulatory burden on the audit firms whilst still ensuring that the audit requirements in the Corporations Act are being complied with. Treasury supports this approach. With these sentiments in mind, Treasury considers that it would be appropriate to explore any scope to review the FRC’s auditor independence function having regard to the fact that ASIC has now instituted an ongoing audit inspection program which focuses on both auditor independence and audit quality requirements.

FINDINGS: AUSTRALIA’S AUDIT REVIEW PROCESSES IN THE CONTEXT OF AUDIT QUALITY

Key finding 7

ASIC’s audit inspection program is in line with the methodologies and best practice standards adopted by audit oversight bodies in the major developed economies. ASIC’s role as an independent oversight regulator with clear statutory powers is an important feature of the Australian system. The reliance that the US Public Company Accounting Oversight Board has been prepared to place on the Australian audit regulation system for purposes of its joint audit inspection process with ASIC is testament to the high regard it has placed on ASIC’s performance as an independent statutory audit regulator.

Key finding 8

Treasury proposes, in conjunction with ASIC, to seek the views of key stakeholders on whether ASIC’s audit inspection reporting model should be brought into line with the reporting models adopted in Canada, the UK and the US in relation to public reports on individual audit firm inspections.

Key finding 9

While there have been reported criticisms of the role of auditors in recent corporate failures, these appear to raise issues relating to an individual auditor’s competence and professional judgment rather than any systemic problem within the auditing profession. Contravention of the audit requirements are subject to a range of sanctions which are enforced by ASIC in appropriate cases. Treasury expects that ASIC’s investigations into recent corporate failures and future ASIC public inspection reports, covering periods of difficult economic conditions during the economic downturn, are likely to highlight a number of specific areas where audits generally could be improved, including in relation to adequate audit documentation.
Key finding 10
The quality review programs conducted by each of the three professional accounting bodies perform a valuable role in promoting audit quality and ethical conduct within the audit profession as an important component of the co-regulatory framework in Australia. The professional quality reviews complement the ongoing audit inspection program conducted by ASIC. The completion of the three-year charter of the Audit Quality Review Board (AQRB) will mean that in future, the major audit firms will be subject only to an ASIC inspection (or ASIC/US Public Company Accounting Oversight Board joint inspection) and a quality review conducted by one of the professional accounting bodies, which will result in a reduction in the firms’ compliance burden.

Key finding 11
The Treasury would like to explore with ASIC and the FRC whether there is any scope to streamline the work of the two bodies in relation to auditor independence in order to eliminate any duplicated effort. While the FRC’s monitoring and policy advisory role in relation to auditor independence was appropriate immediately after the introduction of the comprehensive auditor independence regime under CLERP 9, these requirements have now been bedded down, and it is clear that auditor independence is only one of the key drivers of audit quality. ASIC has developed a wide-ranging Audit Inspection Program which encompasses all aspects of audit quality, including auditor independence. The FRC’s annual Auditor Independence Report is largely based on the annual report that ASIC prepares on its Audit Inspection Program.

There would appear to be two options that should be explored:

• retain the status quo; or

• remove the auditor independence function from the FRC on the basis that its work in this area significantly duplicates the work that ASIC performs in the context of its ongoing Audit Inspection Program.
PART 5: AUDIT FIRM ARRANGEMENTS AND PROCESSES

5.1 Three of the drivers of audit quality recognised by the UKFRC can be grouped under ‘audit firm arrangements and processes’:

- the culture within the firm;
- the skills and personal qualities of audit partners and staff; and
- the effectiveness of the audit process.

5.2 The Treasury endorses the conclusions of the UKFRC in relation to these drivers of audit quality and notes that they dovetail with ASIC’s audit inspection program methodology.

THE CULTURE WITHIN THE FIRM

5.3 The UKFRC has included the following indicators in relation to a firm’s culture in the framework that it has developed for audit quality:

- The culture of an audit firm is likely to provide a positive contribution to audit quality where the leadership of an audit firm:
  - creates an environment where achieving high quality is valued, invested in and rewarded;
  - emphasises the importance of ‘doing the right thing’ in the public interest and the effect of doing so on the reputation of both the firm and individual auditors;
  - ensures partners and staff have sufficient time and resources to deal with difficult issues as they arise;
  - ensures financial considerations do not drive actions and decisions having a negative effect on audit quality;
  - promotes the merits of consultation on difficult issues and supporting partners in the exercise of their personal judgment;
  - ensures robust systems for client acceptance and continuation;
  - fosters appraisal and reward systems for partners and staff that promote the personal characteristics essential to quality auditing;
  - ensures audit quality is monitored within firms and across international networks and appropriate consequential action is taken.

5.4 There were a range of responses from stakeholders to the views expressed by the UKFRC on the culture within an audit firm. The UKFRC has taken into account some of the comments in formulating The Audit Quality Framework. In the light of the international context in which audit quality standards are applied, a number of the comments received by the UKFRC should inform the debate on audit quality in Australia.
• There was a consensus amongst respondents to the UK consultation process that the culture of audit firms is very important to the quality of audits. Many of the audit firms who responded to the discussion paper asserted that their culture was of paramount importance to them and that the emphasis on audit quality within the auditing profession has never been higher.

5.5 Treasury considers that these comments on the UKFRC project would also generally reflect the view of most of the Australian audit firms involved in audits undertaken for the purposes of the Corporations Act. In support of this view, we note the following:

• The FRC commissioned a report in 2007, *Evaluation of how professional and business ethics are applied in practice by accounting firms*, by a consultant, Banarra Sustainability Assurance and Advice.39 Three of the key findings of the Banarra report are that:

  - ethical practices are highly valued, especially in the context of the firms’ demonstrated understanding that unethical practices damage their reputations and brands;
  
  - organisational values are articulated by all the seven firms that were surveyed by Banarra. As a result of this values-based building of culture and the other evidence collected, Banarra was able to conclude that the firms are focused on actioning preferred behaviours and these include ethical behaviours; and
  
  - size does not matter as there were no clear significant differences between the Big 4 and the significant other firms reviewed, but there were differences between individual firms.

• The observations of the AQRB in all the reports it has issued on the reviews it has undertaken of the Big 4 audit firms also support Treasury’s observation.

• Treasury notes that paragraph 18 of ASQC 1 *Quality Control for Firms that perform Audits and Reviews of Financial Reports, Other Financial Information, and Other Assurance Engagements* expressly requires a firm to ‘establish policies and procedures designed to promote an internal culture recognising that quality is essential in performing engagements’.

5.6 The AQRB has made some particularly insightful key findings in its final 2008 report on leadership and values in the Big 4 audit firms in the context of the global financial crisis:

The leaders of all the firms in their internal communications to partners and staff continue to emphasise that audit quality is of paramount importance. This message is frequently coupled with a reminder that the firm’s reputation is its biggest asset and relies to a substantial extent on this concept of commitment to quality.

The AQRB review teams paid particular attention this year to the way in which firms responded to the growing global financial crisis. All the firms showed leadership by way of staff bulletins and education seminars devoted to the effects of the crisis and how engagement teams should plan their audits to respond appropriately. Key challenges and heightened risks were identified in regard to matters such as asset valuations, going concern considerations, treatment of borrowings, impairment of non-financial assets such as goodwill and financial statement disclosure of complex financial instruments.

---

The leadership of each firm has committed substantial resources and senior people to responsible and time-consuming roles in the areas of quality, risk and legal regulation. These functions are also supported by significant staff resources below partner level.\textsuperscript{40}

AQRB has seen evidence that firm leaders are prepared to take decisive and strong disciplinary action whenever there is evidence of quality shortcomings.

5.7 A number of audit firms who responded to the UKFRC considered that ‘regulatory creep’ is threatening the culture they have developed to support audit quality. They believe that this manifests itself in a number of ways, including:

- pressure on firms to meet changing requirements that involve more work without a corresponding increase in fees;
- monitoring by the regulatory body leading to a more compliance-based approach to auditing; and
- the rate of change, and the consequential need for training, causing difficulties.

5.8 The Future of Auditing Report devotes a whole chapter to the issue of increasing audit prescription: Chapter 11, Increasingly Prescriptive Audits — A Distraction for Auditors. The Future of Auditing Report identified the following key issues:

Is the increasingly prescriptive nature of auditing a distraction to the auditor?

To what extent, if any, has the increasingly prescriptive nature of auditing, including documentation, resulted in a check-list mentality that is to the detriment of auditors’ judgment and the quality outcome of the audit?

Given additional audit procedures now required, do audit budgets give less scope to: a) understand the client; and b) delve into issues that arise?

Will the additional audit procedures encourage over-auditing?\textsuperscript{41}

5.9 The Future of Auditing Report asserts that while the increased documentation requirements arose separately from the creation of legal backing, owing to concurrent changes in International Auditing Standards, the complexity of this has been heightened by the presence of legal backing. Interestingly, however, the Future of Auditing Report notes that in response to a survey it undertook, a majority of respondents, including those closest to the production of audit opinions, do not believe that the new regulatory requirements cause a distraction from the major objective of the audit.

5.10 There were a diverse range of responses from interviewees within the Future of Auditing Report project on the issues of increased prescription, check-lists and whether this had a negative effect on the quality of the audit. Treasury considers that the most well-balanced and insightful responses were provided by the standard setter interviewees, which in fact closely reflects Treasury’s own view on these issues. The Future of Audit Report has summarised the responses received from the standard setters in the following terms:

Standard setters give nuanced responses to the question of prescription as a distraction. They acknowledge the risk of it leading to a check-list approach, but can see the potential for it also to improve the audit and argue that, in a normative sense, increased prescription, especially

\textsuperscript{40} AQRB Third Report on the Quality of Audits Performed by Participating Auditors of Public Interest Entities, op. cit., page 14.

\textsuperscript{41} The Future of Auditing Report, op. cit., pages 455-456.
around documentation, should not lessen the more judgmental aspects of an audit. Generally, there is support for what the regulator is attempting to achieve and the increased documentation is seen as a positive in that it provides an evidence base for a claim of a job well done.\footnote{ibid., page 480.}

5.11 The AQRB in its final 2008 report noted that extensive use of checklists has the risk of creating a ‘box ticking’ mentality with consequent loss of critical audit judgment. The AQRB said that checklists should be an aid to professional judgment, not supplant it.

5.12 Treasury’s general response to the concerns raised about a more compliance-based approach to auditing is that the critical importance of the identification of risk by the auditor, and the exercise of professional judgment is so embedded in the whole suite of Australian Auditing Standards that the increased prescription, should not be seen as a distraction from the proper purpose of an audit. The increased emphasis on adequate documentation in the Auditing Standards should also be supported as providing evidence that an auditor has actually exercised their professional judgment in relation to a particular audit issue. Quality documentation by an auditor should also be perceived as an important measure to reduce litigation risks arising from claims against the auditor for a defective audit.

5.13 Treasury considers that the measures that have been adopted in Australia to strengthen the audit regulation framework since the spate of high-profile corporate collapses around 2001 (including Enron and other companies in the US and HIH in Australia) and the consequent world-wide collapse in the credibility of financial reporting and the audit function, have contributed significantly to the enhancement of audit quality and the restoration of confidence in the value of the audit function while maintaining the appropriate regulatory balance.

5.14 The UKFRC also reported that there was a desire from stakeholders for more information about the firms’ policies and the actions that they take to embed a culture of quality within their organisations. In response to these comments, the UKFRC said that it hoped that audit firms would use the ‘drivers of audit quality’ framework to structure annual communications about their policies and the actions they take to ensure high-quality audits are performed. The UKFRC suggested that such communications could form part of the ‘Transparency Reports’ that are already being issued by the major audit firms and which are now required by law under the EU’s Statutory Audit Directive which took effect from 29 June 2008.\footnote{op. cit., n. 24.} The link between an audit firm’s internal culture in relation to audit quality and the imposition of transparency requirements is worthy of consideration in the Australian regulatory environment.

5.15 Article 40 of the EU’s Statutory Audit Directive requires statutory auditors and audit firms to publish on their websites, within three months of the end of each financial year, annual transparency reports that include at least the following:

- a description of the legal structure and ownership;

- where the audit firm belongs to a network, a description of the network and the legal and structural arrangements in the network;

- a description of the governance structure of the audit firm;

- a description of the internal quality control system of the audit firm and a statement by the administrative or management body on the effectiveness of its functioning;

\footnote{ibid., page 480.}
• an indication of when the last quality assurance review took place;

• a list of ‘public interest entities’ for which the audit firm has carried out statutory audits during the preceding financial year;

• a statement concerning the audit firm’s independence practices which also confirms that an internal review of independence compliance has been conducted;

• a statement on the policy followed by the audit firm concerning the continuing education of statutory auditors;

• financial information showing the importance of the audit firm, such as the total turnover divided into fees from statutory audits and fees charged for other assurance services and other non-audit services; and

• information concerning the basis for partner remuneration (the directive states that Member States may in exceptional circumstances disapply this requirement to the extent necessary to mitigate an imminent and significant threat to the personal security of any person).

5.16 In the UK, effect to the transparency report requirement in the EU’s Statutory Audit Directive was given through the Statutory Auditors (Transparency) Instrument 2008 published by the Professional Oversight Board (POB), one of the UK FRC’s operating bodies, which will require statutory auditors to prepare and publish a transparency report in respect of financial years commencing on or after 6 April 2008.

5.17 The POB published an informative note in May 2009 commenting on the voluntary transparency reporting by the largest UK audit firms (ahead of the UK statutory requirement taking effect). The POB considered that its note would be useful to:

• give some analysis of the information in these initial reports;

• indicate where the POB considered that the reports fall short of the requirements for statutory reports; and

• put forward points that the POB would like the relevant firms to consider carefully in finalising their 2009 reports.44

5.18 The UK Audit Commission (a statutory body with responsibility for auditing local government and National Health Service bodies in the UK) has had regard to the EU Transparency Report requirements and voluntarily publishes an annual Quality Report. In its 2008 Quality Report the Commission summarised the perceived benefits of a transparency report in the following terms:

• it demonstrates the Commission’s unequivocal commitment to delivering audit quality;

• it provides assurance to audited bodies and key external stakeholders about the arrangements the Commission has put in place to ensure audit quality and the underlying strength of the Commission’s audit practice; and

• it enables audited bodies and key stakeholders to compare the Commission’s practice with audit firms and other audit agencies.

5.19 The US Treasury Committee report has made the following recommendation in relation to increased transparency by audit firms:

Urge the PCAOB to require that, beginning in 2010, larger auditing firms produce a public annual report incorporating (a) information required by the EU’s Eighth Directive, Article 40 Transparency Report deemed appropriate by the PCAOB, and (b) such key indicators of audit quality and effectiveness as determined by the PCAOB in accordance with Recommendation 3 in Chapter VIII of this Report. Further, encourage the PCAOB to require that, beginning in 2011, the larger auditing firms file with the PCAOB on a confidential basis audited financial statements.45

5.20 In framing this recommendation, the US Treasury Committee noted that:

• auditing firms and investors have expressed support for requiring US auditing firms to publish reports similar to the EU’s Article 40 Transparency Report;

• the Committee believes that the information about audit quality indicators could improve audit quality by enhancing the transparency of auditing firms and notes that some foreign affiliates of US auditing firms provide such indicators in public reports in other jurisdictions; and

• for several years auditing firms in the UK have published annual reports containing audited financial statements pursuant to limited liability partnership disclosure requirements as well as a discussion of those statements, a statement on corporate governance, performance metrics, and other useful information.

5.21 IOSCO released a consultation paper, Transparency of Firms that Audit Public Companies, in September 2009.46 The paper is part of a study by IOSCO to determine whether enhancing the transparency of audit firms’ governance, audit quality indicators, and audited financial statements may serve to maintain and improve audit quality and the availability and delivery of audit services. Treasury proposes to monitor the progress of the IOSCO consultation process for purposes of the development of any requirements in Australia in relation to transparency reporting.

5.22 Treasury notes that there is no statutory requirement under the Corporations Act for auditors to publish information on their websites similar to that required under the EU transparency report. The Big 4 audit firms, however, as part of their participation in the AQRB quality review program, have prepared and published Quality Control Reports (QCRs) on their respective websites. Each of these QCRs are also published on the ASRB website. The QCRs provide detailed information about the system of quality control that each firm has adopted over its respective accounting and auditing practices.

5.23 The information in the QCRs prepared by each of the major audit firms has been classified by reference to the key requirements in APES 320 Quality Control for Firms and ASA 220 Quality Control for Audits of Historical Financial Information as well as the auditor independence requirements in the Corporations Act.47 The information provided in the QCRs appears to be far more detailed and informative than that provided on audit quality by the major UK audit firms in their respective 2008 voluntary transparency reports. With the cessation of the AQRB quality review program, Treasury is

47 The applicable standard from 1 January 2010 requiring firms to establish internal systems of control is ASQC 1 Quality Control for Firms that Perform Audits and Reviews of Financial Reports and Other Financial Information, and Other Assurance Engagements.
of the view that serious consideration should be given to the introduction of a mandatory requirement for audit firms undertaking Corporations Act audits to prepare and publish on their websites a transparency report along the lines of the corresponding requirement under the EU’s Statutory Audit Directive and the QCRs prepared by each of the major audit firms in accordance with the AQRB arrangements. The publication of such reports may assist in bridging the audit expectations gap (discussed in Part 6 below). This would bring Australia into line with the trend in major overseas jurisdictions.

**FINDINGS: THE CULTURE WITHIN THE FIRM**

**Key finding 12**

There is credible evidence to support Treasury’s view that Australian audit firms generally regard their internal culture as critically important in relation to audit quality. Treasury’s view is supported by the focus of ASIC’s ongoing auditor inspection program, the observations of the AQRB, the conclusions of the FRC’s Banarra report, the emphasis on professional judgment within the auditing standards and the requirements of Auditing Standard ASQC 1 Quality Control for Firms that perform Audits and Reviews of Financial Reports, Other Financial Information, and Other Assurance Engagements.

**Key finding 13**

While Treasury acknowledges the concerns raised that a more compliance-based approach to auditing may affect audit quality, it considers that within the Australian audit regulation framework, there are strong incentives to ensure that audit firms strive for a culture of excellence in relation to audit quality. In this context, we note the emphasis placed on professional judgment and the identification of risk throughout the suite of auditing standards issued by the AUASB, ASIC’s proactive audit inspection program with its focus on audit quality and auditor independence and the requirements of Auditing Standard ASQC 1 Quality Control for Firms that perform Audits and Reviews of Financial Reports, Other Financial Information, and Other Assurance Engagements.

**Key finding 14**

Treasury proposes to discuss with stakeholders whether they see value in the Corporations Act being amended to require audit firms that undertake an audit for the purposes of the Corporations Act, to publish on their websites an annual transparency report in line with the requirement under the EU’s Statutory Audit Directive and the Quality Control Reports (QCRs) published by the Big 4 audit firms in accordance with the AQRB arrangements. The publication of such reports may also assist in bridging the audit expectations gap. This proposal would bring the Australian audit regulation framework into line with corresponding developments in the EU, the UK and the US.

**THE SKILLS AND PERSONAL QUALITIES OF AUDIT PARTNERS AND STAFF**

5.24 The UKFRC report found that there was widespread agreement among stakeholders that technical skills, personal qualities and practical experience of audit partners and staff are key drivers of audit quality.

5.25 The UKFRC identified the following indicators in relation to this driver of audit quality.

- The skills and personal qualities of audit partners and staff are likely to make a positive contribution to audit quality where:
- partners and staff understand their clients’ business and adhere to the principles underlying auditing and ethical standards;

- partners and staff exhibit professional scepticism in their work and are robust in dealing with issues identified during the audit;

- staff performing detailed ‘on site’ audit work have sufficient experience and are appropriately supervised by partners and managers;

- partners and managers provide junior staff with appropriate ‘mentoring’ and ‘on the job’ training; and

- sufficient training is given to audit personnel in audit, accounting and industry specialist issues.

5.26 The indicators identified by the UKFRC appear to reflect some of the concerns raised in the submissions received in response to the earlier UKFRC discussion paper.48

• There was little support for a fundamental review of the examination process leading to the qualification of accountants in the UK. There was, however, greater support for auditors receiving more ‘on the job’ training, mentoring and post-qualification technical training.

• A number of companies and investor representatives expressed reservations about the way that audit fieldwork is undertaken. They considered that much of the detailed work is undertaken by relatively inexperienced staff who, in order to ensure that their work is comprehensive and consistent, are required by their firms to adhere to somewhat rigid methodologies.

- In response to this criticism, the UK audit firms supported their existing approach on the basis of their investment in training and methodologies and because junior members of the team are supervised by senior staff and partners. The audit firms argued that the staffing model used helps the professional development of junior staff, as they are given responsibility early and are able to learn from the experience of their more senior peers. One of the Big 4 firms commented that under the present ‘pyramid structure’, partners and managers are heavily involved in the key risk areas of an audit and staff members are adequately briefed, trained and supervised on the roles that they are assigned to.

- The UKFRC noted that the education committee of IFAC had recently issued IES 8 Competence requirements for Audit Professionals. The UKFRC commented that in its view, the practical experience relevant to an audit professional suggested in IES 8 is greater than the current minimum requirements set by the UK professional accounting bodies to meet the requirements of the UK Companies Act. The UKFRC made an observation that the manner and extent to which the UK accounting profession adopts IES 8 may have an impact on the way that audit fieldwork is undertaken.

: The UKFRC agreed with the accounting bodies that a taskforce, ideally comprising representatives of audit firms, professional bodies and other stakeholders, should be established to consider the UKFRC’s interpretation of IES 8, the potential impact of IES 8 on the training of auditors and the concerns expressed in response to the discussion paper.

• The UKFRC noted that there is agreement that mandatory rotation of audit partners is needed to avoid ‘client capture’ and to ensure independence. However, in response to its discussion paper, some audit firms took the view that premature rotation of audit partners creates a threat to audit

quality and that the period of rotation in the UK (five years) should be aligned with the requirements in the EU’s Statutory Audit Directive and the IFAC Code of Ethics (seven years). While the five-year rotation period for the audit engagement partner in relation to audits of listed companies has been retained, the UK Auditing Practices Board has recently revised the relevant ethical standard to allow audit committees to extend the rotation period from five to seven years in certain circumstances for periods commencing from 15 December 2009.49

5.27 The Future of Auditing Report contains some valuable survey results and conclusions which are relevant to the skills and personal qualities of audit partners and staff as one of the key drivers of audit quality in Australia. The Future of Audit Report has addressed these issues in considerable detail in three Chapters:

- Chapter 6: Developing Business Acumen and Client and Industry Knowledge.
- Chapter 7: Attracting and Supporting Staff.
- Chapter 8: Retention of Staff.

5.28 In a perceptive observation, the Future of Auditing Report notes that while the issues of industry expertise, client knowledge and business acumen are intertwined, the three have differentiating and distinctive characteristics:

Business acumen is about having a commercial sense and a general insight into the operations of business; industry expertise is having knowledge and appreciation of the particular characteristics, risks and critical issues of an industry or group of industries that share similar characteristics relevant for an auditor; and client knowledge is a more specific understanding of the issues and characteristics of a particular auditee, its management and its operations.50

5.29 The Future of Auditing Report also concluded that the personal attributes and characteristics of staff assigned to an audit engagement also play a role in relation to the demand for and supply of audit services, which have policy implications for the audit firms, the professional accounting bodies and the university schools of accounting.

These attributes include but are not limited to maturity, tenacity, self-assertiveness, resilience and integrity — many of which feed into the notion of ‘emotional intelligence’. The existence and development of such attributes appear to have key policy implications with respect to the selection of new employees for audit firms, the training and education before their selection and the professional skills development and training of the accounting professional bodies.

Throughout the interviews, the supply and the demand side of the market for audit services commented on the importance of these various personal attributes. There is, however, little evidence from suppliers that psychological testing to measure these skills is part of the selection process. Additionally, from the authors’ own knowledge, the specific development of nurturing and attainment of educational outcomes for these graduate attributes are not uppermost in educators’ minds in the construction or delivery of degree programs relevant to the accounting profession. Similarly, the principal accounting bodies do not seem to have these personal attributes as things that are nurtured or tested in professional development courses, at least for those in the early years of their membership of their professional bodies. This is the case even though it is these junior people who are most exposed to the interface with clients. One important policy implication is that the supply side and the professional bodies together with

49 See n. 18 above.
the universities need to examine their recognition of, enthusiasm for and support of the
development of these personal attributes. It could be that the inclusion of psychology subjects
or at least their encouragement as electives to be taken by commerce and business students
during university degrees should be explored.51

FINDINGS: THE SKILLS AND PERSONAL QUALITIES OF AUDIT PARTNERS AND
STAFF

Key finding 15
Treasury is of the view that stakeholders in Australia would also agree that the skills and personal
qualities of audit partners and staff are important key drivers of audit quality. It is generally
recognised that auditing is a knowledge-based service where the primary input is the expertise of
individual auditors and their staff.

Key finding 16
Treasury considers that the conclusions of the Future of Auditing Report in relation to the
development, use and value of industry expertise, client knowledge and business acumen, the
personal attributes of audit staff and the attraction, support and retention of staff should be
considered by the audit firms, the professional accounting bodies and the universities.

THE EFFECTIVENESS OF THE AUDIT PROCESS

5.30 The UKFRC identified the following indicators in relation to this driver of audit quality:

• An audit process is likely to provide a positive contribution to audit quality where:
  – the audit methodology and tools applied in the audit are well structured and:
    : encourage partners and managers to be actively involved in audit planning;
    : provide a framework and procedures to obtain sufficient appropriate audit evidence
effectively and efficiently;
    : require appropriate audit documentation;
    : provide for compliance with auditing standards without inhibiting the exercise of judgment;
    and
    : ensure there is effective review of audit work;
  and where audit quality control procedures are effective, understood and applied;
  – high-quality technical support is available when the audit team requires it or encounters a
situation it is not familiar with;

51 ibid., pages 249-250.
the objectives of ethical standards are achieved, providing confidence in the integrity, objectivity and independence of the auditor;

- the collection of sufficient audit evidence is not inappropriately constrained by financial pressures.

5.31 The indicators listed by the UKFRC reflect the comments received in response to the earlier UKFRC discussion paper, although respondents agreed that the UKFRC had generally identified the correct features of an effective audit process.

5.32 The main concerns identified in the responses to the UKFRC discussion paper were as follows:

- There is support for ‘principles based’ auditing standards and concern that international auditing standards are becoming more prescriptive. Many respondents noted a growing trend towards prescription in International Standards on Auditing (ISAs).

- The importance of the ‘true and fair view’ principle underlying both the preparation and the audit of financial statements is strongly supported by many respondents. Stakeholders noted that the ‘true and fair view’ lies at the heart of the professional judgment of the auditor and that to move away from this basic tenet would undermine the confidence that users place on accounts.

- There is a widely shared view that the volume of recent changes to legislation in the UK, accounting standards and aspects of audit regulation has been significant and that a period of stability is now needed. Respondents said the changes to the regulatory framework had been difficult for the audit firms to assimilate and there is a need for a period of stability to allow those changes to be fully understood and embedded in the firms’ systems. The UKFRC noted that a common view amongst respondents is that too much time is spent on ensuring that the financial accounting is right and too little checking that the financial statements fairly reflect the underlying economic conditions of the business.

- Many respondents were concerned that there is a lack of global consistency in the quality of audits provided. Some believe that this is exacerbated by the lack of transparency of the global firms’ international network arrangements. The UKFRC has said that it will continue its efforts through the International Forum of Independent Audit Regulators (IFIAR) and the European Group of Auditors’ Oversight Bodies (EGAOB) to promote global consistency in audit quality. In particular, the UKFRC has noted that it will consider this matter in giving effect to provisions in the EU’s Statutory Audit Directive on third-country auditors.

5.33 Treasury considers that the UKFRC has covered the relevant issues comprehensively and we only have a few comments from the Australian perspective:

- With regard to the ‘true and fair view’, it is noted that section 297 of the Corporations Act requires the financial statements and notes to the accounts for a financial year to give a true and fair view of the financial position and performance of the reporting company or entity. If the financial statements and notes prepared in compliance with the accounting standards would not give a true and fair view, additional information must be included in the notes to the financial statements necessary to give a true and fair view. The auditor who conducts the audit is required under section 307 of the Corporations Act to form an opinion about whether the financial report gives a ‘true and fair view’ and is in compliance with the accounting standards.

- While Treasury appreciates the tension between more prescriptive auditing standards and the need for auditors to exercise professional judgment rather than adopting a ‘tick the box’ compliance approach, we consider that there are important incentives built into the Australian framework to ensure that auditors exercise professional judgment:
- the ‘true and fair’ view requirement in the Corporations Act and the requirement under the auditing standards for an auditor to use professional judgment (see, for example, paragraph 36 of ASA 100 Preamble to AUASB Standards and ASA 220 Quality Control for Audits of Historical Financial Information);

- the quality review processes undertaken by ASIC, the professional accounting bodies and the AQRB;

- the investment that audit firms have put into building up and maintaining professional audit expertise.

• ASIC is an active member of IFIAR where the issue of global consistency of audits will be progressed.

**FINDINGS: THE EFFECTIVENESS OF THE AUDIT PROCESS**

**Key finding 17**

The ‘true and fair view’ principle and the requirement for the financial report to comply with the accounting standards are appropriately addressed under the Corporations Act.

**Key finding 18**

Treasury considers that the exercise of professional judgment by auditors rather than the adoption of a ‘tick-a-box’ approach to auditing is adequately provided for under the Australian audit regulation framework.

**Key finding 19**

Global consistency in the quality of audits is an important policy objective having regard to the increasingly international focus of trade and commerce and the internationalisation of financial markets. Treasury considers that this objective is best promoted at international forums such as the International Forum of Independent Audit Regulators (IFIAR) where ASIC is an active member. The Treasury also promotes the message of global consistency in the quality of audit whenever bilateral, multilateral and regional opportunities arise.
PART 6: THE RELIABILITY AND USEFULNESS OF AUDIT REPORTING

6.1 The UKFRC has identified the following indicators in relation to this driver of audit quality:

- Audit reporting is likely to provide a positive contribution to audit quality where:
  - audit reports are written in a manner that conveys clearly and unambiguously the auditor’s opinion on the financial statements and that addresses the needs of users of financial statements in the context of applicable law and regulations;
  - auditors properly conclude as to the truth and fairness of the financial statements;
  - communications with the audit committee include discussions about:
    - the scope of the audit;
    - the threats to auditor objectivity;
    - the key risks identified and judgments made in reaching the audit opinion; and
    - the qualitative aspects of the entity’s accounting and reporting and potential ways of improving financial reporting.

6.2 Treasury agrees with the thrust of these indicators identified by the UKFRC. We note that the UKFRC’s investigation of audit quality was predicated on the basis that its work would be undertaken within the existing legal and regulatory framework. The UKFRC was aware that some commentators have questioned whether the existing financial reporting regime is capable of meeting the needs of users and other stakeholders in the current business and investment environment. However, the UKFRC concluded that such extensive changes had been made in recent years to the financial reporting regime in the UK, that any fundamental review of the financial reporting regime, including audit, should take place after such changes have been fully assimilated by all concerned.

EXPECTATIONS GAP

6.3 A major issue that is relevant to the issue of the reliability and usefulness of audit reporting is the so-called ‘expectations gap’. IOSCO has cited the following definition of the term ‘expectations gap’ in a consultation paper it has recently released on auditor communication:

The difference between what the public and users of financial statements perceive the role of an audit to be and what the audit profession claim is expected of them during an audit.\(^5\)

6.4 The Future of Auditing Report has examined this issue in considerable detail. It has devoted three chapters around the issues relating to the expectations gap:


45
6.5 The Future of Auditing Report has commenced its consideration of the expectations gap with an examination of the ‘understandability’ of the audit because it considers that the two concepts overlap and that ‘having understandability of the audit is a necessary but not sufficient condition for a path to lowering or eradicating an expectations gap’. While it was considered that the complexity of financial statements was outside the scope of the report and auditors should not be held accountable for it, the report considered that this complexity had consequences for the audit process and the information-handling capabilities of users. This is because ‘the extent of this complexity can pose a limitation to what might be done to enhance what is reported in the audit opinion and audit information presented elsewhere’.

6.6 The Future of Auditing Report concludes that there is very genuine concern about the level of complexity and information load jointly contained in the financial reporting disclosures. The report considers that this joint level of complexity makes significant reduction in the expectations gap improbable. The Future of Auditing Report recommends that the FRC establish a taskforce to examine this issue.

We recommend that the FRC gives consideration to setting up a task force that examines the competing challenges of comprehensive and technically accurate financial reporting and auditing information together with the need for understandable disclosures that have genuine utility to the capital market.

6.7 The overarching conclusion of the Future of Auditing Report in relation to the expectations gap has been summarised in the following terms:

In summary, the audit expectations gap continues to exist, is complex and multifaceted (existing at least between users and suppliers, purchasers and suppliers and regulators and suppliers) and at the least is costly to the efficiency of the market for information within the capital market and could have many other costs associated with it. It goes without saying that the audit expectations gap should be minimised to the extent possible. There needs to be, however, recognition that the audit expectations gap will never be closed and that eliminating differential incentives for a gap to exist and ‘educating’ all stakeholders are not possible. Focusing on stakeholders who are motivated and have the capability to have their knowledge and understanding of audit and its outcomes raised and focusing on specific topics known to be the subject of misunderstandings (for example, materiality, use of the term ‘test basis’) are the best strategies. Because of shared objectives and sophistication levels, the gap between suppliers and regulators should be given the highest priority in terms of gap minimisation.

6.8 The Future of Auditing Report has suggested that all parties in the market for audit services should take responsibility to minimise the audit expectations gap to the extent possible.

---

53 The Future of Auditing Report, op. cit., page 36, and see Chapter 3 generally.
54 ibid., page 58.
55 ibid., pages xxix–xxx.
Fraud and the expectations gap

6.9 Treasury notes that the issue of the auditor’s responsibility to detect fraud has been referred to in much of the audit literature and studies. IOSCO has noted that the expectations gap includes the difference in perception related to the auditor’s role in detecting fraudulent financial reporting. In a study undertaken by the UK APB (one of the UKFRC’s operating bodies) in November 1998, *Fraud and Audit: choices for society*, it was noted that:

- most material frauds involve directors and/or senior management;
- management fraud, particularly if it also involves collusion with third parties, is unlikely to be detected as part of the statutory audit of financial statements; and
- at the same time, shareholders, creditors and the public expect auditors to find material fraud.\(^\text{56}\)

6.10 The APB received negative responses to proposals for an expanded role for auditors to help companies establish effective systems to prevent fraud:

- companies and institutional investors were unwilling to bear additional audit costs;
- increased auditor involvement in the way businesses undertook their activities would put undue constraints on the freedom of directors to organise companies’ activities as they considered most effective; and
- auditors were unwilling to accept a larger role without some mitigation of the risks of litigation.

6.11 ASA 240 *The Auditor’s Responsibility to Consider Fraud in Audit of a Financial Report* imposes mandatory requirements in relation to the auditor’s responsibility to consider fraud in an audit of a financial report. However ASA 240 is limited to two types of fraud relating to a financial statement — misstatement resulting from misappropriation of assets and misstatement resulting from fraudulent financial reporting. ASA 240 also provides guidance on the inherent limitations of an audit in the context of fraud.

6.12 Having regard to the limitations on the detection of fraud by an auditor, a strategy that has been adopted is to introduce requirements into companies legislation which provide an incentive on management, who are primarily responsible for the prevention and detection of fraud, as a guard against the risk of fraud. In Australia, the CLERP 9 reforms require, under section 295A of the Corporations Act, that the CEO or CFO make a declaration that, in their opinion, the financial statements and notes are in accordance with the Act (including the accounting standards) and with the requirement that the financial statements and notes give a true and fair view of the company’s financial position.

6.13 Another example of such a strategy is section 418 of the UK Companies Act 2006 which requires the directors’ report to contain a statement:

- that so far as each director is aware, there is no relevant audit information of which the auditors are unaware; and
- that each director has taken all the steps they should have taken as a director to make themselves aware of such information and to establish that the auditors are aware of it.

---

Section 418 complements the provisions in the UK Companies Act which establish auditors’ rights to information for the purposes of an audit. The explanatory note on section 418 (which was incorporated into the UK Companies Act by the Companies (Audit, Investigations And Community Enterprise) Act 2004) states that the aim of the provision is to ensure that each director will have to think hard about whether there is any information that they know about or could ascertain which is needed by the auditors in connection with preparing their report.

If a false statement is given, each director who knew the statement to be false, or was reckless as to whether it was false, and failed to take appropriate steps to prevent the directors’ report from being approved, is guilty of an offence and liable to imprisonment and/or a fine.

The Corporations Act contains a suite of provisions that are designed to ensure that the financial statements comply with the Act’s requirements and that the auditor has adequate access to relevant information:

- the CEO and CFO of a listed entity are required to provide a declaration to the directors under section 295A that:
  - the financial records of the entity have been properly maintained in accordance with section 286 of the Act;
  - the financial statements and notes for the financial year comply with the accounting standards; and
  - the financial statements and notes for the financial year give a true and fair view;

- the directors of a listed entity must only provide the directors’ declaration required under subsection 295(4) of the Corporations Act after the CEO/CFO declaration has been given to the directors;

- the auditor’s power to obtain information (section 310) is complemented by the obligation imposed on the officers of a company to assist the auditor (section 312). Obligations are also imposed on the auditor to report suspected contraventions of the Corporations Act to ASIC (section 311); and

- directors involved in contravention of section 1307 (falsification of books), section 1308 (false or misleading documentation) or section 1308 (false or misleading material) are liable to criminal prosecution.

The Corporations Act does not contain a provision similar to section 418 of the UK Companies Act 2006. However, Treasury considers that arguably, the suite of provisions in the Corporations Act imposing disclosure obligations on the directors in relation to the financial statements and to the auditor provide similar protection to that provided by section 418 of the UK Companies Act.

A paper issued by the six largest global audit firms, Global Capital Markets and the Global Economy: A Vision From the CEOs of the International Audit Networks, made some instructive observations about the issue of fraud and the expectations gap:

Perhaps no single issue is the subject of more confusion, yet is more important, than the nature of the obligation of auditors to detect fraud — or intentional material misstatement of financial information by public companies. After all, fraud was at the centre of various corporate financial reporting scandals earlier this decade. Allegations of fraud are central in the ongoing lawsuits brought by investors against individuals and companies, as well as against audit networks for alleged failures to uncover them.
It is essential that all parties engaged in business reporting — employees, management, directors, auditors and policy makers — put in place appropriate procedures and policies to prevent and detect fraud. Nonetheless, there is a significant ‘expectations gap’ between what various stakeholders believe auditors do or should do in detecting fraud, and what audit networks are actually capable of doing, at the prices that companies or investors are willing to pay for audits.

But there are limits to what auditors can reasonably uncover, given the limits inherent in today’s audits. Specifically, unless companies or investors are willing to pay auditors to police all of a company’s transactions, auditors are limited to using indirect means to ascertain whether fraud has occurred.

Hence, the ‘expectations gap’ arises because many investors, policy makers and the media believe that the auditor’s main function is to detect fraud, and thus, where it materialises and auditors have failed to find it, the auditors are often presumed to be at fault. Given the inherent limitations of any outside party to discover the presence of fraud, the restrictions governing the methods auditors are allowed to use, and the cost constraints of the audit itself, this presumption is not aligned with the current auditing standards.

What is sorely needed is a constructive dialogue among investors, other company stakeholders, policy makers and our own professionals about what should be done to close or at least narrow the ‘expectations gap’ relating to fraud.57

6.17 The US Treasury Committee report also considered the issue of fraud and the ‘expectations gap’ and linked this issue to the adequacy of the existing standard audit report. The Committee urged the PCOAB to undertake a standard-setting initiative to consider improvements to the auditor’s standard reporting model. The Committee further urged the PCAOB and the SEC to clarify in the auditor’s report the auditor’s role in detecting fraud under current auditing standards.58

6.18 In framing this recommendation, the Committee made a number of pertinent observations:

The Committee notes that the increasing complexity of global business operations are compelling a growing use of judgements and estimates, including those related to fair value measurements, and also contributing to greater complexity in financial reporting. The Committee believes this complexity supports improving the content of the auditor’s report beyond the current pass/fail model to include a more relevant discussion about the audit of the financial statements. While there is not yet agreement as to precisely what additional information is sought by and would be useful to investors and other users of financial statements, the Committee concludes that an improved auditor’s report would likely lead to more relevant information for users of financial statements and would clarify the role of the auditor in the financial statement audit.

In view of the desirability of improving the quality of financial reporting and auditing on a global basis, the PCAOB should also consider the developments in foreign jurisdictions that improve the quality and content of the auditor’s report and should consult with international regulatory bodies as appropriate. The PCAOB should also take cognizance of the proposal’s potential legal ramifications, if any, to auditors.

Accordingly, the Committee believes that the auditor’s report should articulate clearly to investors the auditor’s role and limitations in detecting fraud. The Committee believes that expressly communicating to investors, other financial statement users, and the public the role of auditors in finding and reporting fraud would help narrow the ‘expectations gap’.59

Auditor communications, the expectations gap and the standard audit report

6.19 IOSCO issued a consultative paper in September 2009, Auditor Communication (the IOSCO paper), which importantly draws together the linkages about auditor communications, the expectations gap and the adequacy of the standard audit report.60 Treasury considers that the IOSCO paper makes a significant contribution because its analysis of the complex policy issues highlights the need for rigorous cost/benefit analysis of any proposals to make changes to the standard audit report, in order to ensure that any remedial measures to address perceived shortcomings in the standard audit report do not result in unintended consequences that negate potential benefits. The IOSCO paper encapsulates the fundamental policy issue to be considered in the following terms:

The standard audit report is the primary means by which auditors communicate to users of financial statements regarding their audits. As such, securities regulators need to carefully consider whether the standard audit report communicates the appropriate information to investors and whether its form and content facilitate audit quality.61

6.20 The IOSCO paper describes the evolution of the audit report in a number of jurisdictions and identifies the drivers of change to the report. It notes that the current format of the audit report developed by the IAASB has been adopted in many jurisdictions, including Australia (see ASA 700 The Auditor’s Report on a General Purpose Financial Report). It is instructive to note the policy drivers identified in the IOSCO paper underlying the current IAASB standard audit report:

In developing its standard audit report in 2004, the IAASB sought to (i) increase consistency in reporting between jurisdictions and (ii) increase the understandability of the auditor’s role and of the auditor’s report by using simple, understandable language and being as concise as possible, while still aiming to be informative and including clear explanations. In addition to revisions intended to achieve these goals, the audit report was revised to include more robust descriptions of the respective responsibilities of management and the auditor, an updated description of the audit process and to clarify the scope of the auditor’s responsibilities with respect to internal control. The revision resulted in a two-part standard audit report, which includes: (i) the auditor’s report on the audit of the financial statements and (ii) other reporting responsibilities, as applicable (for example, where national laws, regulations, and/or auditing standards impose additional responsibilities on auditors beyond the audit responsibilities defined by the ISAs).62

6.21 Having considered the similarities and differences in the underlying objectives of audit reports throughout the world, the IOSCO paper concluded that the primary objective of audit reports is relatively consistent: to clearly express the auditor’s opinion on the financial statements and to describe the basis for that opinion. The challenge that IOSCO perceives for regulators and standards setters is expressed in the following terms:

59 ibid., Chapter VII, pages 17-18.
60 Auditor Communications, Consultation Paper, op. cit., n. 52.
61 ibid., page 1.
62 ibid., page 3.
The question remains, however, whether this objective is being met and whether it alone satisfies investor’s needs for information about the audit process and its results. Thus, the challenge for regulators and standard setters is to determine how best to achieve and balance various objectives, while recognising that if they desire global consistency in auditor reporting, the standard audit report must be capable of accommodating the different reporting requirements that exist across certain jurisdictions.63

6.22 The IOSCO paper notes the criticisms of some stakeholders that the standard audit report has not been changed to adequately reflect the growing complexity in business, financial reporting and auditing and that some stakeholders have more broadly questioned the usefulness of the standard audit report. These criticisms of the standard audit report can essentially be classified under three categories:

• expresses an opinion that is binary in nature, that is, a pass/fail model.

• contains ‘boilerplate’ and technical language; and

• does not reflect the level of effort and judgment inherent in an audit, thereby exacerbating the expectations gap.64

6.23 The IOSCO paper is particularly useful in highlighting that it is not sufficient to address these criticisms simply by posing the question of whether the standard audit report should be changed or not. A proper analysis requires a deeper consideration of the nature of the so-called information gap and whether the auditor should play a role in addressing any perceived gaps. The IOSCO paper identifies the following policy issues that arise:

• If investors are receiving inadequate information to make investment decisions, by whom should this information gap be filled?
  – It may be that any identified information gaps should be filled by those charged with the management and governance of a company rather than the auditor.
  – If an information gap should be filled by those other than the auditor, should the auditor have any role in relation to the additional disclosures?

• If information gaps should be filled by the auditor, then should this be addressed through changes to the standard audit report or should other forms of auditor communication be considered?
  – The IOSCO report notes that other information about the auditor might render changes to the standard audit report unnecessary. For example, audit firm transparency reports (see key finding 12 above) may address concerns raised over the lack of information about the firm and the engagement team that conducted the audit, which makes it difficult to evaluate audit quality.65 The IOSCO paper also refers to the concern that the nature of auditing is not widely understood by users of audit reports and that rather than educating users through changes to the standard audit report, information about the nature of auditing could be provided through more general communications to investors.66

6.24 The IOSCO paper identifies a number of consequences and risks that could arise from changes to the standard audit report which would need to be carefully evaluated:

63 ibid., page 7.
64 ibid., page 8.
65 ibid., page 14.
66 ibid., pages 14-15.
Legal risks: there are concerns that changes to the standard audit report might expose an auditor to increased litigation, particularly where the auditor was required to provide more subjective information.

Practical challenges: these risks involve the question of whether changes to the standard audit report could fundamentally change the nature of an audit, leading to increased audit costs, and whether audits could be completed in a timely manner. The introduction of more subjective information could also lead to inconsistencies in audit reporting within individual jurisdictions and across jurisdictions.

Regulatory or statutory obstacles: the IOSCO paper notes that some national or statutory frameworks (such as Australia’s and many adopted in Europe) dictate the form and content of the standard audit report and that if global consistency in auditor reporting is desired, any changes to the standard audit report must be capable of accommodating the different reporting requirements that exist across certain jurisdictions.

The various research projects, expert committee reports and consultation papers that have been undertaken at both the domestic and international levels which we have referred to above, have been a rich source of material for Treasury’s consideration of the issues relating to the reliability and usefulness of audit reporting as a key driver of audit quality.

Our first conclusion is that global consistency is a critical goal that must always be borne in mind in considering any changes to the standard audit report. In the Australian context, we consider that it will be essential for the AUASB to continue (in accordance with the FRC’s strategic direction) to base the Australian Auditing Standards on the international standards issued by the IAASB. The need for global consistency and the maintenance of international best practice underlines the importance of Australia’s continued input to, and participation within, international bodies such as the IAASB, IFIAR and IOSCO.

Treasury’s current view on strategies to minimise the expectations gap has been significantly informed by the wide disparity between the sophistication of retail and more sophisticated investors in terms of their understanding of financial and audit reports and the fact that the audit reports are frequently not read. Accordingly, we are concerned that more disclosures in the audit report might in fact result in more confusion and have the perverse effect of actually increasing the existing gap between users and the suppliers of audit services. We are more attracted to strategies (mentioned in the Future of Auditing Report and the IOSCO paper) involving:

• The preparation of plain English educational material which explains the scope of the audit and that an audit involves sampling and is risk-focused with a view to providing reasonable assurance in relation to the integrity of the financial statements rather than an iron clad guarantee. We consider that the audit firms, the professional accounting bodies and other industry bodies such as the Australian Institute of Company Directors (AICD) and the Australian Shareholders Association should be involved in the preparation and wide dissemination of this material.

• The audit firms and the professional accounting bodies could explore measures to encourage confidence in the audit framework and the professionalism of the audit, such as the preparation of transparency reports by the audit firms and wide publicity being given to the quality review programs undertaken by the professional accounting bodies.

Many interviewees in the research project conducted by the Future of Auditing Report expressed concern about the perceived expectations gap between the regulators and the suppliers of

67 ibid., pages 15-16.
audit services, particularly in light of the establishment of ASIC’s ongoing audit inspection program. Treasury’s view is that any such expectations gap should be left to ASIC and the audit firms to resolve. It is understandable that there would have been tensions when ASIC first commenced its audit inspections in 2005-06. However, the Treasury understands that as each round of annual inspections has been completed, there has been a growing acceptance and understanding by the firms of the audit quality focus of ASIC’s audit inspection methodologies and processes.

FINDING: THE RELIABILITY AND USEFULNESS OF AUDIT REPORTING

Key finding 20

Treasury is of the view that global consistency is a critical goal that must always be borne in mind in considering any changes to the standard audit report. In the Australian context, we consider that it will be essential for the Auditing and Assurance Standards Board (in accordance with the FRC’s strategic direction) to continue to base the Australian Auditing Standards on the standards issued by the International Auditing and Assurance Standards Board (IAASB). The need for global consistency and the maintenance of international best practice underlines the importance of Australia’s continued input to, and participation within, international bodies such as the IAASB, the International Forum of Independent Audit Regulators (IFIAR) and the International Organisation of Securities Commissions (IOSCO).

Key finding 21

Key stakeholders should consider the suggestion of the Future of Auditing Report that a task force be established to examine the competing challenges of comprehensive and technically accurate financial reporting and auditing information, together with the need for understandable disclosures that have genuine utility to the capital market. Treasury notes however, that the scope for any remedial measures may be limited because much of the complexity in financial disclosure reflects the requirements of international accounting standards, and that the standards must have regard to the ever-increasing complexity of financial transactions and the business environment.

Key finding 22

Treasury proposes to encourage focused discussion with key stakeholders including ASIC, the FRC, the Auditing and Assurance Standards Board (AUASB), the major audit firms and the professional accounting bodies on strategies to minimise identified audit expectation gaps. Treasury is of the view that any proposals to change the current standard audit report would need to be subjected to rigorous cost/benefit analysis to ensure that the risks associated with any changes do not negate the potential benefits. In that context, Treasury is concerned that because of the wide disparity between the sophistication of retail and more sophisticated investors in terms of their understanding of financial statements and audit reports, any changes to the standard audit report may have the perverse effect of introducing confusion among some users, leading to a widening of the expectations gap.

Treasury considers that it will be important for stakeholders to explore the possibility of other forms of auditor communication which may make any changes to the standard audit report unnecessary. In particular, Treasury will encourage the audit firms, the professional accounting bodies and other industry bodies such as the Australian Institute of Company Directors (AICD) and the Australian Shareholders’ Association (ASA) to prepare and widely disseminate educational material explaining the nature and scope of the audit. This material should explain that an audit involves sampling and is risk-focused, with a view to providing reasonable assurance in relation to the integrity of the financial statements rather than an iron-clad guarantee. In this context, Treasury also is of the view that
consideration should be given to audit firms being required to prepare and publish a transparency report on their websites (see key finding 14).
PART 7: FACTORS OUTSIDE THE CONTROL OF AUDITORS

7.1 The UKFRC’s discussion paper identified a number of factors outside the control of auditors as key drivers of audit quality because it is important to appreciate that the audit process does not take place in a vacuum. The UKFRC asserted that there are various external influences that can impact the ability of auditors to fully and effectively discharge their responsibilities.

7.2 Following consideration of responses to its discussion paper, the UKFRC identified the following indicators relevant to this driver of audit quality:

- an approach to corporate governance within the reporting entity that attaches importance to corporate and financial reporting and to the audit process;
- audit committees that are active, professional and robust in dealing with issues identified during the audit;
- shareholders that support auditors, where appropriate, thereby increasing the likelihood that directors and management will comply with their obligations in relation to the preparation of reliable financial statements;
- in its discussion paper Promoting Audit Quality, the UKFRC said that ‘in circumstances where the auditor’s primary responsibility is to report to shareholders, it is important that those shareholders respond in a considered and constructive way when auditors take a public position in relation to the way in which a company has prepared its financial statements or in relation to the conduct of the directors and management of a company’. The UKFRC considered that if shareholders take appropriate action in support of auditors in such circumstances, there will be an increased likelihood that directors and management more generally will comply with their obligations.
- reporting deadlines that allow the opportunity to carry out an audit without undue reliance on work performed before the end of the reporting period;
- appropriate agreed arrangements for any limitation of liability;
- an audit regulatory environment that focuses on the drivers of audit quality.

7.3 Treasury considers that the indicators identified by the UKFRC are equally applicable in the Australian context.

CORPORATE GOVERNANCE AND THE AUDIT COMMITTEE

7.4 A strong underlying policy rationale of the CLERP 9 reforms was the need to strengthen the corporate governance approach to financial disclosure and the audit process. In this context, it is important to recognise the Principles of Good Corporate Governance and Best Practice Recommendations (the Corporate Governance Principles) published by the ASX Corporate Governance Council in March 2003 which complement the statutory reforms in the Corporations Act. The Corporate Governance Principles have been revised and published as a second edition in 2007. The foreword to the second edition noted that:
This document marks the first revision of the Council’s corporate governance Principles and Recommendations since they were issued in March 2003. This is testimony to the durability of Australia’s flexible, principles based approach to corporate governance. While some other major jurisdictions are unwinding their governance frameworks because of unworkability, Australia has been able to refresh its approach rather than undertake a rewrite.

7.5 Principle 4 of the Corporate Governance Principles addresses the safeguarding of integrity in financial reporting. This Principle recommends that companies should have a structure to independently verify and safeguard the integrity of their financial reporting. The central tenet of Principle 4 is that companies should establish an audit committee. ASX Listing Rule 12.7 requires companies included in the S&P/ASX All Ordinaries Index (the top 500 companies) to have an audit committee. Listing Rule 12.7 also requires the top 300 listed companies to comply with the recommendations of the Corporate Governance Principles on the composition, operation and responsibility of the audit committee. Principle 4 of the Corporate Governance Principles explains the purpose of the audit committee, the optimum structure and composition of the committee, the need for independent and financially literate members and the requirement of a charter for the committee. The responsibilities of the audit committee set out in Principle 4 include:

- assessment of whether external reporting is consistent with committee members’ information and knowledge and is adequate for shareholder needs;
- assessment of the management processes supporting external reporting;
- procedures for the selection and appointment of the external auditor and for the rotation of external audit engagement partners;
- recommendations for the appointment, or if necessary, the removal of the external auditor;
- assessment of the performance and independence of the external auditors. Where the external auditor provides non-audit services, the report should also state whether the audit committee is satisfied that provision of those services has not compromised the auditor’s independence (see also paragraph 3.13 of this paper above, which describes the disclosure obligations imposed under the Corporations Act on directors of listed companies in relation to auditor-provided non-audit services and the requirement that the disclosures made by the directors be in accordance with the advice provided by the company’s audit committee);
- assessment of the performance and objectivity of the internal audit function;
- the results of the committee’s review of risk management and internal control systems; and
- recommendations for the appointment or, if necessary, the dismissal of the head of internal audit.

7.6 The UK APB, in its *A Review of Activities* released in April 2008, commented that ‘the increasingly active involvement of audit committees in the consideration of auditor independence’ was one of ‘a number of helpful developments over the past three years which have served to decrease the threats to auditor independence’.

7.7 While the requirements set out in the ASX Corporate Governance Principles in relation to the structure, composition and responsibilities of the audit committee appear to be in line with international best practice standards, having regard to the critical role the audit committee plays in relation to the integrity of the company’s financial reporting and audit process, Treasury is of the view

---

that it would be appropriate to consider whether the requirement for a company listed on the S&P/ASX All Ordinaries Index to establish an audit committee should be included in the Corporations Act rather than the Listing Rules and whether the existing requirement should be extended to all listed companies. In this context, the question arises whether, from an enforcement and regulatory perspective, it would be sufficient to rely on section 793C of the Corporations Act which empowers ASIC to make an application to the court in relation to the failure to comply with or enforce a listing rule. Another related issue that Treasury considers should be examined is whether the requirement that the top 300 listed companies comply with the recommendations of the Corporate Government Principles on the composition, operation and responsibility of the audit committee should be applied to all 500 companies in the S&P/ASX All Ordinaries Index.

7.8 Treasury considers that it is important to note that a director’s duties as a member of the audit committee are governed by sections 180-184 of the Corporations Act, which substantially codify the general law principles as established by case law. In a presentation on directors’ duties to the 2008 ASIC Summer School, Mr Neil Young QC (a former Justice of the Federal Court of Australia) said that subsection 180(1) of the Corporations Act imposes a ‘sliding standard of care and diligence that a reasonable person would exercise in the office held by and having the same responsibilities as the hypothetical reasonable director’. Mr Young advanced the proposition (based on the case law) that a director’s position on the audit committee, particularly as Chair of the audit committee, would tend to increase the standard of care and diligence expected of the director, as reflected by the special responsibilities placed on members of the audit committee by the ASX Corporate Governance Principles. In a more recent presentation Mr Young has summarised the application of the statutory requirements in the following terms:

The statutory duty of care and diligence applies whatever the role of the director — chairperson, managing director, audit committee member or non-executive — but the practical content of the duty varies with the particular circumstances of the company and the particular responsibilities undertaken by the director. In its application, therefore, the statutory duty imposes a sliding scale of care and diligence that is tailored to the individual director’s role and responsibilities along a continuum that stretches from the full time managing director and fully engaged chairperson to part-time non-executive directors. However, courts now recognise a basic duty on all directors to understand the company’s financial position and take the necessary steps to guide and monitor the management of the company.

FINDINGS: CORPORATE GOVERNANCE AND THE AUDIT COMMITTEE

Key finding 23

Audit committees play a critical role in ensuring the integrity of a company’s financial reporting and the audit process, including the independence and objectivity of the external auditor. The audit committee also plays a wider role in ensuring that the company has sound internal financial control systems. Overall, a well-functioning audit committee underpins the assurance that the board of directors gives to shareholders in relation to the company’s financial statements and the audit process.

---

69 Section 185 of the Corporations Act provides that the statutory requirements in sections 180-184 supplement the duties of directors under the general law and do not replace them.

The ASX Corporate Governance Principles and Recommendations in relation to the structure, composition and responsibilities of the audit committee appear to be in line with international best practice standards.

However, having regard to the important role that the audit committee plays in the good governance of a company, Treasury considers that it would be appropriate to examine whether the requirement for a company listed on the S&P/ASX All Ordinaries Index to establish an audit committee should be included in the Corporations Act rather than the Listing Rules, and whether the existing requirement should be extended to all listed companies. Another related issue that Treasury considers should be examined is whether the mandatory requirement for the top 300 listed companies to comply with the recommendations of the ASX Corporate Governance Council’s Corporate Governance Principles and Recommendations on the composition, operation and responsibility of the audit committee should be applied to all 500 companies listed on the S&P/ASX All Ordinaries Index. Treasury proposes to explore these issues with relevant stakeholders including ASIC, the Australian Institute of Company Directors (AICD) and the ASX.

Treasury notes that a director who is a member of the audit committee is subject to the duties of a director contained in sections 180-184 of the Corporations Act and under the general law, and that the application of these requirements would tend to increase the standard of care and diligence expected of the director having regard to the special responsibilities placed on members of the audit committee by the ASX Corporate Governance Principles.

Treasury also considers that it is important to recognise that the establishment of an audit committee does not diminish the ultimate responsibility of the board of directors to ensure the integrity of the company’s financial reporting and audit process.

**REGISTERED COMPANY AUDITORS**

7.9 In Australia, a person is required to be registered by ASIC as a registered company auditor in order to undertake an audit of a company or other entity required under the Corporations Act. The registration requirements in relation to registered company auditors are robust and are designed to ensure high-quality audits. The eligibility requirements for registration as a registered company auditor are set out in section 1280 of the Corporations Act. These cover:

- qualifications (paragraph 1280(2)(a)): an applicant must demonstrate prescribed academic qualifications and the completion of a prescribed course in auditing; or have other qualifications and experience that ASIC considers equivalent to both these requirements;

- skills (paragraph 1280(2)(b)): an applicant must satisfy all the components of an ASIC-approved competency standard (paragraph 1280A); or have the prescribed level of practical experience (time based) or experience that ASIC considers to be equivalent;

- capacity and fit and proper (paragraph 1280(2)(c)): ASIC must be satisfied that the person is capable of performing the duties of an auditor; and is a fit and proper person to be registered as an auditor.

7.10 There is also a parallel registration system for an authorised audit company under the Corporations Act. In the context of the eligibility criteria for registration as an authorised audit company under section 1299B of the Corporations Act, it should be noted that each director of the company must be a registered company auditor.
7.11 Treasury considers that there are two policy issues under the Australian framework relevant to the requirements for registration as a company auditor and audit quality that warrant further consideration.

**Approved competency standard**

7.12 The first issue concerns the approved competency standard for the purposes of sections 1280 and 1280A of the Corporations Act. The competency standard was developed by CPA Australia and the ICAA and published in November 2004 after it was approved by ASIC. In framing the competency standard, the two professional bodies had regard to an IFAC discussion paper issued in June 1998, *Competence Based Approaches to the Professional Preparation of Accountants*. IFAC’s International Accounting Education Standards Board (IAESB) has subsequently issued a series of International Education Standards (IESs) that express the benchmarks that IFAC member bodies and their members are expected to meet in the preparation and continued development of professional accountants. IESs 1 to 6 were published in October 2003, IES 7 in May 2004 and IES 8 in July 2006. IES 8 became effective from 1 July 2008.

7.13 Treasury considers that it would be timely, in the light of the development and publication by IFAC of IESs 1 to 8, for the professional accounting bodies to review the existing approved competency standard for the purposes of sections 1280 and 1280A of the Corporations Act in consultation with ASIC. Any revision of the existing competency standard would need to be approved by ASIC. This would ensure that the approved competency standard was consistent with international best practice standards.

**Decline in number of registered company auditors**

7.14 The second issue relates to the progressive decline in the number of registered company auditors in Australia (see table below which also shows the number of authorised audit companies).

<table>
<thead>
<tr>
<th>Date</th>
<th>Registered company auditors</th>
<th>Annual percentage change</th>
<th>Authorised audit companies</th>
</tr>
</thead>
<tbody>
<tr>
<td>30 June 2003</td>
<td>6,440</td>
<td>Not applicable</td>
<td>Not applicable</td>
</tr>
<tr>
<td>30 June 2004</td>
<td>6,506</td>
<td>1.02</td>
<td>Not applicable</td>
</tr>
<tr>
<td>30 June 2005</td>
<td>6,163</td>
<td>-5.27</td>
<td>18</td>
</tr>
<tr>
<td>30 June 2006</td>
<td>5,848</td>
<td>-5.11</td>
<td>36</td>
</tr>
<tr>
<td>30 June 2007</td>
<td>5,658</td>
<td>-3.25</td>
<td>60</td>
</tr>
</tbody>
</table>

7.15 The progressive decline in the number of registered company auditors may be explained by a range of factors, including the relative attractiveness of non-audit services work that may be more lucrative than traditional audit work, and the regulatory environment that auditors are now subject to in Australia and overseas. Treasury understands though, from informal consultations it has held with stakeholders, that the most significant driver behind this trend is demographic factors, with a significant proportion of the existing population of registered company auditors nearing retirement. This suggests that the decline in number of registered company auditors is likely to continue. This issue is already problematic in country towns and regional centres. In this context, it should be noted that the availability of registered company auditors is also relevant for a range of statutory audits under state and territory legislation where the audits are required to be undertaken by registered company auditors.

7.16 Treasury considers that there are two strategies that may assist in addressing the decline in the number of registered company auditors:

- State and Territory governments should consider whether it would be appropriate to ensure that registration as a registered company auditor is not the sole qualification for purposes of eligibility
to undertake a statutory audit required under state and territory legislation. Such an approach would be consistent with the views expressed in the 1997 Review of Requirements for the Registration and Regulation of Company Auditors at paragraphs 244-245 (a report of a working party of the Ministerial Council for Corporations).

- Consideration could be given to the introduction of simplified financial reporting and audit requirements for smaller companies limited by guarantee (which predominantly have a not-for-profit focus). There are approximately 11,000 companies limited by guarantee. The Australian Government is currently examining proposals to amend the Corporations Act which would exempt companies limited by guarantee that fell below a threshold set at $250,000 of consolidated revenue that are not deductible gift recipients from all financial reporting, directors’ report and auditing requirements under Chapter 2M of the Corporations Act. As a means of reducing audit costs, the proposals also envisage that companies limited by guarantee that exceeded the $250,000 threshold of consolidated revenue and have a consolidated revenue of less than $1 million being given the option of having their financial information subject to a ‘review’ rather than an ‘audit’. The review or audit for a company limited by guarantee that fell into such a category could be undertaken by either a registered company auditor or a member of a professional accounting body with a practising certificate.71

**FINDINGS: REGISTERED COMPANY AUDITORS**

**Key finding 24**

Treasury considers that it would be timely, in the light of the development and publication by the International Federation of Accountants (IFAC) of International Education Standards for Professional Accountants IESs 1 to 8, for the professional accounting bodies to review the existing approved competency standard for the purposes of sections 1280 and 1280A of the Corporations Act. This would ensure, once the revised standard had been approved by ASIC, that the approved competency standard was consistent with international best practice.

**Key finding 25**

Treasury proposes to seek the views of stakeholders on two strategies that may assist in addressing the decline in the number of registered company auditors:

- State and Territory governments should consider whether it would be appropriate to ensure that registration as a registered company auditor is not the sole qualification for purposes of eligibility to undertake a statutory audit required under State and Territory legislation. This finding is consistent with the views expressed in the 1997 Review of Requirements for the Registration and Regulation of Company Auditors at paragraphs 244-245 (a report of a working party of the Ministerial Council for Corporations).

- Consideration could be given to the introduction of simplified financial reporting and audit requirements for smaller companies limited by guarantee (which predominantly have a not-for-profit focus). There are approximately 11,000 companies limited by guarantee. Treasury notes that the Australian Government is currently examining proposals to amend the Corporations Act which would exempt companies limited by guarantee that fell below a threshold set at $250,000 of consolidated revenue and that are not deductible gift recipients, from all financial

reporting, directors’ report and auditing requirements under Chapter 2M of the Corporations Act. As a means of reducing audit costs, the proposals also envisage companies limited by guarantee, that exceeded the $250,000 threshold of consolidated revenue and have a consolidated revenue of less than $1 million, being given the option of having their financial information subject to a ‘review’ rather than an ‘audit’. The review or audit for a company limited by guarantee that fell into such a category could be undertaken by either a registered company auditor or a member of a professional accounting body with a practising certificate.

AUDITOR LIABILITY

7.17 The UKFRC’s discussion paper commented that for many years, the exposure that auditors face from professional negligence claims has been thought to be a stimulus to quality of the audit work undertaken by audit firms. However, the UKFRC also noted that over the past 15 years, litigation has increased to a level that is beyond the capacity of the firms to bear or to obtain insurance cover for. The UKFRC said that this was due to the ever-increasing size of the companies and transactions involved and to the changing nature of the law.

7.18 The policy issues relating to auditor liability are being given high priority by the EU Commission in the context of its current Audit Package work program. In a speech delivered to the EU’s Committee on Legal Affairs (JURI Committee) on 19 December 2007, Commissioner Charlie McCreevy linked auditor liability with the issue of lack of choice when selecting an audit firm. Commissioner McCreevy noted that this was particularly acute in the EU market for audit engagements of listed companies. According to an EU study, the ‘Big 4’ audit firms account for 85 per cent of audits of listed companies in the EU. Commissioner McCreevy made the following observations:

So why is this market so concentrated? Well mainly because of the principle of unlimited, joint and several liability which is characteristic for the auditing profession. This is exacerbated by the fact that auditors are unable to obtain sufficient insurance cover. This acts as a disincentive for potential new entrants to the auditing market for large listed companies. But not only do we not have any new players coming into the market, we also run the risk of losing some of the existing players. As I mentioned earlier, there is a serious risk that catastrophic claims might cause the collapse of one of the major audit networks. As we have only a very limited number of networks, such a collapse would pose a significant threat for the ongoing supply of high quality audits.

I believe that we should make every endeavour to encourage new entrants into the market for large audits and to create the conditions for them to invest in building stronger international networks.

But how can we convince them to make the significant financial commitment needed to expand into the market for larger audits, if liability risks are high and insurance cover is not available? We cannot reasonably promote the objective of greater choice without first addressing the liability risks facing the audit profession.

7.19 Commissioner McCreevy informed the Committee on Legal Affairs that the EU Commission intended to put forward a Recommendation to Member States in the first quarter of 2008 asking them to limit auditor liability.

7.20 At a high-level Roundtable on the Quality of Public Company Audits sponsored by the International Organisation of Securities Commissions (IOSCO) in Paris on 1 June 2007, one of the key topics debated was the impact of auditor liability on auditor behaviour and audit quality. A number of the participants linked this issue to the long-term sustainability of audit firms (which is important
for capital markets) having regard to the unavailability of insurance to cover the largest claims against audit firms with their unlimited liability.

7.21 The Final Report of the US Treasury Committee released in October 2008, contains an extensive discussion on the issue of auditor liability and the possible impact of the current US liability system on audit effectiveness and the continued sustainability of the public company auditing profession in the US. The Committee, however, made no recommendations on this issue because it was unable to reach a consensus on the complex issues raised.

7.22 Australia has introduced a range of measures to address the issue of auditor liability (and professional liability more generally). The CLERP 9 reforms included a measure to permit audit firms to incorporate and the Australian Government participated with State and Territory governments in introducing Australia-wide regimes relating to proportionate liability and the capping of liability under professional standards legislation. The proportionate liability regime has been in operation since 2004. Capping of auditor’s liability is effected through the state and territory Professional Standards legislation. CPA Australia and the ICAA currently (as at 1 September 2009) have approved schemes under the Professional Standards legislation in all jurisdictions except Tasmania, where their respective schemes are currently being processed. The NIA has an approved scheme under the NSW Professional Standards legislation.

FINDINGS: AUDITOR LIABILITY

Key finding 26

Australia has introduced a number of measures to address the issue of auditor liability and in terms of international best practice standards can be considered to be at the forefront of reforms in this area.

Treasury proposes to monitor, in consultation with key stakeholders including the audit profession, the impact on auditor liability of the increasing use of class actions in Australia and the role of litigation funders.

THE REGULATORY ENVIRONMENT

7.23 The UKFRC has included the regulatory environment in its indicators relating to factors outside the control of auditors. As discussed above under Parts 3 and 4, the Treasury considers that the audit regulation framework and the audit quality review processes should both be recognised as separate key drivers of audit quality.

7.24 IOSCO issued a consultation paper Exploration of Non-Professional Ownership Structures for Audit Firms in September 2009. The key policy driver underlying the preparation of this paper is IOSCO’s concern about the risks to the capital markets presented by concentration in the market for large public company audit services. IOSCO proposes to examine potential barriers to entry that may hinder the emergence of greater audit choice for large public entities. IOSCO has decided, as the beginning stage of this project, to consider audit firm ownership restrictions.

7.25 While concentration in the audit market raises very important policy issues, it lies outside the primary scope of Treasury’s review of audit quality. However, the IOSCO consultation paper recognises that any proposals to remove ownership restrictions may have an impact on audit firm competence, professionalism, independence and audit quality. The IOSCO paper discusses the potential benefits of removing ownership restrictions and the possible adverse consequences and seeks stakeholder views on these issues. Treasury proposes to monitor the progress of IOSCO’s work on this project, not only because of the audit quality implications but because concentration in the audit market for large public entities is a matter of concern at both the domestic and global levels.

7.26 The importance of the domestic audit regulation framework as a driver of audit quality has been heightened by the fact that regulatory responses to audit quality issues are now increasingly taking on an international dimension as a result of the globalisation of capital markets.

7.27 A recurring theme that appeared in the research undertaken by Treasury for this strategic review on audit quality is that the globalisation of capital markets has compelled policy and regulatory coordination and collaboration internationally. It is therefore appropriate that the concluding observations in Treasury’s strategic review should recognise the important nexus between the domestic regulatory framework, the globalisation of capital markets and audit quality. This view has been strongly endorsed by the US Treasury Committee report:

The Committee believes that these types of global regulatory coordination and cooperation are important elements in making sure public company auditing firms of all sizes are contributing effectively to audit quality. The Committee strongly supports the efforts of the PCAOB to enhance the efficiency and effectiveness of its programs by communicating with foreign regulators and participating in global regulatory bodies. The Committee urges the PCAOB and its foreign counterparts to continue to improve regulatory cooperation and coordination on a global basis.